2005

A Status Report
of the
Auditor General of Canada
to the House of Commons

FEBRUARY

Office of the Auditor General of Canada

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The February 2005 Report of the Auditor General of Canada comprises eight chapters and a Message from the Auditor General.

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For copies of the Report or other Office of the Auditor General publications, contact

Office of the Auditor General of Canada
240 Sparks Street, Stop 10-1
Ottawa, Ontario
K1A 0G6

Telephone: (613) 952-0213, ext. 5000, or 1-888-761-5953
Fax: (613) 943-5485
E-mail: distribution@oag-bvg.gc.ca

Ce document est également disponible en français.

© Minister of Public Works and Government Services Canada 2005
Cat. No. FA3-40/2005E
ISBN 0-662-39157-8

Auditor General of Canada
Vérificatrice générale du Canada

To the Honourable Speaker of the House of Commons:

I have the honour to transmit herewith my first Report of 2005 to the House of Commons, which is to be tabled in the House in accordance with the provisions of subsection 7(5) of the *Auditor General Act*.

Sheila Fraser
Sheila Fraser, FCA
Auditor General of Canada

OTTAWA, 15 February 2005

105-03131/

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A Message from the Auditor General of Canada

Sheila Fraser, FCA
Auditor General of Canada

A Message from the Auditor General of Canada

I am pleased to present my third Status Report to the House of Commons.

One of Parliament's most important roles is to hold the federal government to account for its use of taxpayer dollars. To fulfill its role as watchdog over the public purse, Parliament needs objective, accurate information on how well the government is managing public funds.

The Office of the Auditor General is an independent, reliable source of such information. Since 1977, my Office has conducted performance audits that examine whether the government is managing its programs with due regard to economy, efficiency, and environmental impact and has measures in place to determine their effectiveness.

The information we provide to parliamentarians gives them a better basis for scrutinizing government operations and evaluating the progress of large-scale initiatives to improve governance. Our audits cover a wide range of topics and provide recommendations with the potential to promote positive, lasting change in the way the government functions.

After our audit reports are tabled in the House of Commons, my colleagues and I frequently appear before parliamentary committees—along with representatives of the departments we have audited—to discuss what we have reported. The Standing Committee on Public Accounts often asks departments and agencies to provide action plans for addressing our recommendations, and it holds them to those plans; occasionally, other standing committees do this as well.

In my view, this Status Report demonstrates that the government does act in response to our recommendations and, in fact, does change for the better. In four of the chapters that follow, we conclude that progress has been satisfactory. We describe the positive steps taken by the Canadian International Development Agency, Transport Canada, and the Canadian Nuclear Safety Commission to resolve issues we raised in previous audits. We also conclude that the government's efforts to modernize its management of human resources are on track.

Unfortunately, we cannot say that the other four areas we audited show satisfactory progress. Much work is still needed on several large-scale initiatives to improve government. Canadians need to see more progress in such critical areas as the governance of Crown corporations, the security of the government's information technology, the accountability of foundations, and the management of the government's financial information.

What has made the difference between the satisfactory and the unsatisfactory progress we report here? We found that it has been the scale and complexity of the change that must be managed and the level of co-operation needed across the government to achieve results. Apart from the modernizing of human resources management—still at a very early stage of implementation—each area that showed satisfactory progress was narrowly defined and within the control of a single department or agency of the government. Managing the changes needed in the four other areas has been a greater challenge because the changes involve many departments and agencies, take longer to carry out, and demand managers' leadership and persistence to maintain the necessary momentum.

Satisfactory progress

Transport Canada—Overseeing the National Airports System

In 1992, Transport Canada began to transfer the management of major Canadian airports to not-for-profit airport authorities, while retaining ownership of the airports by granting 60-year leases. By 2003, the 26 airports included in the National Airports System had been transferred. Our audit of the system in 2000 found that Transport Canada did not know the financial impact of the airport transfers and had not yet defined its role as owner, landlord, and overseer of the airports in the National Airport System. It could not say whether airport authorities were adhering to the terms of their leases, and it was not overseeing their financial viability.

Since then, Transport Canada has made satisfactory progress in implementing the recommendations of our 2000 audit. It has almost concluded the National Airports Rent Policy Review, which will allow it to assess the financial impact of transferring airports. It has also clarified and assumed its role as owner, landlord, and overseer of the airports while establishing good working relations with airport authorities.

The Department has determined that airport authorities are complying with the provisions of their leases and maintaining the airport facilities in a condition at least as good as before the transfers. It now monitors annually the financial situation of the airport authorities and oversees the long-term viability of the National Airports System.

Canadian International Development Agency—Financial Compliance Audits and Managing Contracts and Contributions

The Canadian International Development Agency (CIDA) is responsible for managing some $2.6 billion in international development assistance. In 1999 and 2000 audit reports we recommended that CIDA improve its process of awarding contracts and contribution agreements for aid projects. We also said it should document its reasons for deciding not to recover funds in certain cases.

Overall, CIDA has made satisfactory progress in responding to our recommendations. It has made headway in reducing its use of non-competitive agreements, monetizing commodities for deposit to counterpart funds, monitoring project risks, ensuring the sustainability of project benefits, and documenting its decisions on audits of contribution agreements.

However, while conducting our follow-up we became aware of additional weaknesses. For example, we found that although required by policy, CIDA officers rarely analyzed the value of in-kind contributions claimed by recipients or verified that no provision was made for profit. We also noted that in many cases, CIDA released Canadian executing agencies from their obligation to repay amounts falling outside the terms of their agreements, which means that CIDA did not ensure that it paid only for those goods received and services rendered according to the terms of the agreements.

In the last five years, CIDA has sharply increased its use of grants to fund aid projects; we are concerned this could lead to its sacrificing too much control and oversight over how its funds are spent without having analyzed the impact on results.

Canadian Nuclear Safety Commission—Power Reactor Regulation

The Canadian Nuclear Safety Commission (CNSC) regulates the use of nuclear energy and materials to protect the health, safety, security, and environment of Canadians. This includes the licensing and regulation of nuclear power reactors, which we audited in 2000.

On the whole, the CNSC has made satisfactory progress in responding to our recommendations. It has adopted a consistent approach to compliance and enforcement within and across the divisions that plan and conduct compliance inspections of power reactors. It has developed a new scale to rate how well power reactor licensees meet its regulatory expectations, and it has issued key regulatory documents.

Progress has been slower than planned, however, on developing a formal, well-articulated risk-management approach to regulating nuclear power reactors. In response to our previous audit, the CNSC developed an action plan that it posted on its Web site and updated regularly. The action plan called for the establishment of a risk-based approach by the end of 2003. While the CNSC has adopted this approach in its regulating of nuclear substances and uranium mining and processing, it does not yet follow such an approach for power reactor regulation.

Modernization of Human Resources Management: Managing the Reforms

The legislative framework for human resources management in the federal public service is currently undergoing the most fundamental transformation since the mid-1960s. The new *Public Service Modernization Act*, passed in November 2003, is being phased in over several years, so its full impact will not be evident for some time. Given that it is still in the early stages, implementation is proceeding in an orderly way, and progress is satisfactory.

In my view, the government has laid a solid foundation for carrying out the modernization of human resources management. For the most part, roles and responsibilities have been clarified. However, the Treasury Board Secretariat needs to ensure that the activities of the three agencies that now play key parts of the employer role—the Treasury Board Secretariat, Canada School of Public Service, and Public Service Human Resources Management Agency—are better integrated and co-ordinated. In particular, the role of the new human resources management agency should be further clarified to define its expected contribution to human resources governance and its relationship to the other stakeholders.

Some of the major organizational changes required by the new legislation have occurred quite smoothly, such as the transfer of certain functions from the Public Service Commission to the Treasury Board Secretariat and the creation of the new Canada School of Public Service. This is largely due to a strong project management process, which has received effective leadership from the deputy minister community.

If this wide-ranging and complex reform initiative is to be successful over the long term, the government will need to maintain its focus and momentum. This will be a challenge, given the many demands on the public service today. The government needs to clearly define the outcomes it expects from the reform of human resources management and then monitor and report on ongoing progress. It also needs to ensure that the full costs of this reform are monitored, controlled, and reported.

Better reporting will be critical in light of the five-year review of the legislation once it comes into effect. Parliamentary committee review of these reports would be a way to influence the nature, direction, and pace of change and also an opportunity to ensure that momentum is maintained and reforms actually take place.

Unsatisfactory progress

Governance of Crown Corporations

Crown corporations control and manage billions of dollars in public funds. It is therefore vital that they be governed well. In 2000, we expressed concern about the governance practices of Crown corporations and made several recommendations for improvement.

In recent years, high-profile failures among publicly traded corporations in North America have prompted many positive developments in corporate governance. Legislation in the United States (the *Sarbanes-Oxley Act*) and more stringent securities regulations in Canada have turned expectations for good corporate governance of publicly traded corporations into requirements. In our view, many of these changes can be adapted to the governance and accountability framework of Crown corporations.

Our follow-up audit examined what the government and Crown corporations have done to implement the recommendations we made five years ago. We found that the overall response has been unsatisfactory. Although individual Crown corporations have made improvements, progress in responding to most of our recommendations has not been as swift or as extensive as we had expected.

It took more than three years for the government to address some of our key 2000 recommendations by starting the Treasury Board Secretariat review of corporate governance in February 2004.

Board, chair, and CEO appointments are still taking too long, and terms are not adequately staggered. In addition, the responsibilities and expectations of the government regarding Crown corporations still need to be clarified.

The changes in the process for appointing directors of Crown corporations, announced in March 2004, have not yet been fully defined or implemented. These changes were put forward by the government to enhance transparency and increase Canadians' confidence that the best people are being appointed to public institutions. Since none of the government's recent appointments have followed the new process fully as of this writing, we could not assess its impact.

On an encouraging note, however, we observed fewer gaps in the collective skills and expertise of board members. We also found that the composition and operating practices of board audit committees had improved and that audit committees are operating more effectively than in 2000.

In my view, a range of private sector practices could usefully be emulated in Crown corporations. These include ensuring that the board plays a key role in its own renewal and in selecting the chair and CEO; strengthening the independence of boards and audit committees; requiring that the mandate and operations of the board be defined; strengthening corporate values and ethics practices; and improving the quality of reporting and disclosure.

While these practices are not yet expected of Crown corporations, the Treasury Board Secretariat informs us that it is considering them in the review of Crown corporation governance it is now conducting.

Information Technology Security

In our follow-up audit of information technology (IT) security in government, we noted some encouraging signs of improvement. The development of policies and standards has laid a sound foundation for a more secure IT environment in government. Lead agencies and departments are now more involved and committed.

Overall, however, the government has made unsatisfactory progress in strengthening IT security. Two and a half years after revising its Government Security Policy, it still has much work remaining to translate policies and standards into consistent, cost-effective practices that will result in more secure IT.

IT systems in departments and agencies continue to be vulnerable to breaches in security. The majority of departments do not meet the minimum standards of IT security. Vulnerability assessments conducted in departments and agencies over the last two years have revealed significant weaknesses. If these are exploited, the result could be serious damage to government information systems.

I am concerned that members of senior management are not aware of the risks to IT security in their departments and do not understand how breaches of IT security could affect their operations and the federal government's credibility.

Managing Government: Financial Information

The government continues advancing in its use of accrual financial information and improving the quality of the systems supporting that information. However, more work is needed if departments and agencies are to have better financial information for decision making. Better financial information would also improve financial accountability to Parliament—not just result in improved year-end accrual financial information for preparing the government's summary financial statements. The Office of the Comptroller General of Canada needs to lead this initiative by aggressively advancing the use of accrual financial information and promoting the importance of good internal financial controls.

Departments and agencies must take stronger and swifter action to correct weaknesses in their internal financial controls. Integrated, comprehensive internal control systems have a significant role to play in ensuring that high-quality financial information is available for decision making.

I urge the government to finalize its study of accrual-based appropriations and budgeting at the department level and to move forward in this matter. Without direction and guidance, wider use of accrual financial information in decision making will be delayed still further.

I also encourage the Office of the Comptroller General to finalize a plan for resolving all remaining issues for the fair presentation of departmental and agency financial statements. This will be necessary if the government's goal of having such financial statements audited within five years is to become a reality.

Accountability of Foundations

In 1997 the government introduced a new approach to achieving policy objectives—through the transfer of public funds to foundations, which are non-profit corporations that operate at arm's length from government. At March 2004, more than $9 billion had been paid to such foundations. These upfront payments are made many years before they are needed.

Given the magnitude of these transfers, I have repeatedly expressed concern about the governance and accountability of foundations and the government's accounting for its payments to them.

Our performance audits in 1999 and 2002 found that accountability to Parliament had been placed unnecessarily at risk. The essential requirements for accountability to Parliament were not being met—namely, effective ministerial oversight, adequate provision for external audit, and credible reporting of results. We examined progress in these three areas following the 2003 and 2004 Budget plans, in which the government announced its commitment to improve the accountability of foundations.

Despite some changes for the better, progress overall has been unsatisfactory. Mechanisms for ministerial oversight are not adequate for the government to make adjustments in foundations where circumstances have changed considerably. There is no provision requiring foundations to undergo performance audits that are reported to Parliament.

Reporting to Parliament and the public has shown some progress. The government is committed to better reporting in the corporate plans, summaries, and annual reports of foundations and in the Estimates documents of sponsoring departments. But the performance information that is provided is not sufficient for effective parliamentary scrutiny, and it needs to be improved.

Conclusion

The purpose of legislative auditing is not to point fingers and issue stern rebukes when problems occur in public sector management. Audits are intended to be learning tools to help management identify things that could be done better and to recommend specific improvements.

Cynics would have us believe that nothing ever comes of our recommendations to the government. In their view, once the Office's reports are made public and the hoopla dies down, the government returns to business as usual.

I beg to differ. The government does pay attention to our reports. And this Status Report bears this out. In four out of eight cases, departments and agencies made satisfactory progress in responding to our recommendations. We are heartened by their achievements and commend their dedication.

In the four cases of unsatisfactory progress, we recognize the complexity and difficulty of the sweeping changes across government that they entail. Nonetheless, these long-standing, challenging issues must be addressed with renewed vigour and with clear plans and strategies. Our audits have shown that success in these cases will need strong leadership and the ability to maintain focus and momentum over long periods of time. In the end, it will be Canadians who benefit from these vital efforts.

Chapter

1

Information Technology Security

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Information Technology Security

Main Points

1.1 Despite encouraging signs of improvement, the government has made unsatisfactory progress in strengthening information technology (IT) security since our audit in 2002. It has laid a foundation by developing IT security policies and standards, and lead agencies and departments are more involved and committed to IT security. However, two and a half years after revising its Government Security Policy, the government has much work to do to translate its policies and standards into consistent, cost-effective practices that will result in a more secure IT environment in departments and agencies.

1.2 The revised 2002 Policy clarified the roles and responsibilities of the various players in IT security. Since then, lead organizations are co-operating to develop standards and provide guidance and assistance to departments in strengthening their IT security practices. However, many standards have yet to be developed and the Treasury Board Secretariat has not completely fulfilled its oversight role as defined in the Policy.

1.3 Departments and agencies have achieved some progress in developing IT security policies and implementing specific security practices, such as vulnerability assessments. However, their IT systems are vulnerable to breaches in security. The majority of departments do not meet the minimum standards set by the Secretariat for IT security. Vulnerability assessments, conducted in departments and agencies over the last two years, have revealed significant weaknesses that, if exploited, could result in serious damage to government information systems.

1.4 We are concerned that, in many departments and agencies, senior management is not aware of the IT security risks and does not understand how breaches of IT security could affect operations and the credibility of the government. If security weaknesses allowed someone to access a database or confidential information, Canadians' trust in the government would be greatly eroded. Further, if a citizen's privacy were violated because of a failure to keep confidential information secure, it could cause that person hardship and seriously undermine the government's efforts to deliver services to Canadians electronically.

Background and other observations

1.5 In 2002, we found that the revised Government Security Policy, which came into effect in February 2002, was an important step in strengthening security across government. However, the IT security standards to support its implementation in departments and agencies were either non-existent or out of date. Little information on the state of IT security across the government was available because few departments had audited their security programs or monitored their IT security. We also identified other issues that the government needed to address to improve IT security.

Treasury Board Secretariat has responded. The Treasury Board Secretariat's responses to our recommendations are included in this chapter, along with additional information at the end of the conclusion. The Secretariat has responded positively to our recommendations and, in some instances, is already taking action.

Introduction

Cyber incident—Any unauthorized attempt, whether successful or not, to gain access to, modify, destroy, delete, or render unavailable any computer network or system resource.

1.6 In our April 2002 Report, we reported on the state of information technology (IT) security in the federal government. We noted that IT security should be a high priority for management, given increasing cyber incidents and their potential to disrupt an organization's business.

Key findings in 2002

1.7 The 2002 revised Government Security Policy was an improvement over earlier versions of the Policy. More specifically, it

- updated the roles and responsibilities of the Treasury Board Secretariat, which plays a co-ordination and leadership role, and of the 10 entities that provide security guidance and support to departments and agencies; and
- emphasized the importance of IT security to overall government security.

1.8 However, we did have concerns. The operational standards, which departments and agencies follow to implement the policy, were outdated or did not exist. These standards are critical: they define baseline requirements for instituting consistent security measures across government.

1.9 The government was not monitoring how effective the Policy was in strengthening IT security. It had done little monitoring since 1994, and departments and agencies were generally not complying with Policy requirements. The 2002 Policy no longer required departments to audit their security programs every five years and the Royal Canadian Mounted Police to assess departmental security periodically.

1.10 Since 1994, there had been limited government-wide monitoring and oversight of IT security and, as a consequence, little baseline information existed on the state of IT security across government.

Important changes since 2002

1.11 Since 2002, the use of the Internet in government has grown rapidly. It started to accelerate in 1999 with the launch of the Government On-Line (GOL) initiative. GOL will allow Canadians to access key government information and transaction services on-line by the end of 2005.

1.12 To make services and information more accessible, the government has been streamlining its Internet services under three themes: Canadians, Business, and International Visitors. At the departmental level, it is making its services more client-friendly and providing 130 key services on-line. At the same time, three factors are compounding the risk of delivering services on-line:

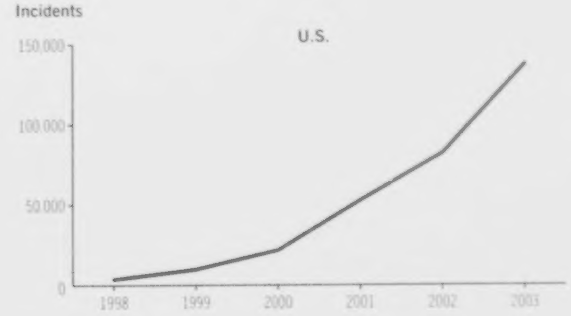
- the availability of on-line tools that can breach the security of IT systems;

- an enormous increase in software and hardware weaknesses that can compromise computer systems and the information they contain; and
- a growing number of people with the knowledge to exploit these weaknesses, often within days of their discovery.

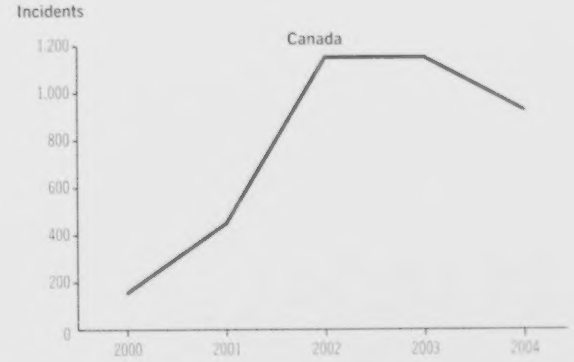
Network attack—A single unauthorized attempt to access or use a network. An **incident**, on the other hand, involves a group of attacks that can be distinguished from other **incidents** by the distinctiveness of the attackers and the degree of similarity of sites, techniques, and timing.

1.13 Cyber incidents have risen significantly since 2001, and the increase and the patterns are similar in Canada and in the U.S. (Exhibit 1.1). However, only a small percentage of incidents are actually reported. Network attacks are a good indicator of the real risks. Since our last 2002 Report, these attacks have increased dramatically, which shows how easily and quickly they can be launched (Exhibit 1.2).

Exhibit 1.1 Cyber incidents detected and reported by third parties in the U.S. and in Canada

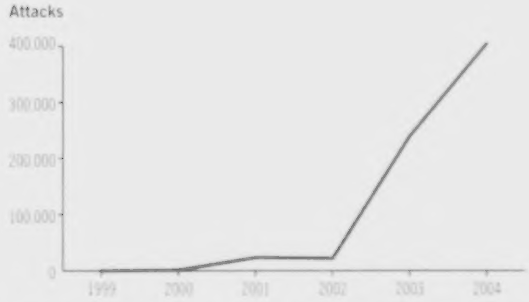


Source: CERT Coordination Centre (U.S.)



Source: CanCERT (Canada)

Exhibit 1.2 Network attacks detected in Canada



Note: These network attacks include a variety of incidents detected by sensors across Canada. They are indicative of the malicious activity that most government and commercial networks experience.

Source: CanCERT (Canada)

1.14 The Government of Canada recognizes that Canadians want on-line services that are secure for business and protect their personal information. In response, it initiated the major Crown project, Secure Channel, an infrastructure that connects Canadians and businesses to the government. The Secure Channel

- incorporates common standards for privacy, security, availability, and reliability;
- offers Internet services to all departments and agencies;
- offers client authentication services, which are being used more and more;
- delivers several GOL services since 2002; and
- will allow Canadians to provide confidential information on their census forms on-line in 2006.

1.15 The government also offers services to users with Web-enabled cell phones or personal digital assistants. The range of these services is increasing. For example, Canadians can now obtain toll-free numbers, up-to-date economic forecasts, or contact information for their members of Parliament.

1.16 Before departments and agencies can deliver their services, either by wireless devices or on-line on the Secure Channel network, they will need to meet stringent baseline IT security standards.

Focus of the follow-up

1.17 The objective of this follow-up was to assess the extent to which the Treasury Board Secretariat and departments have implemented the recommendations that we made on IT security in Chapter 3 of our 2002 Report. We looked at the state of IT security across government, and whether departments and agencies have appropriate frameworks for protecting the security of information and delivering services securely and without interruption. More specifically, we focussed on five key areas:

- co-operation and information-sharing among lead organizations on IT security;
- development and implementation of IT security standards to support policy;
- effectiveness of the Government Security Policy and existing security measures;
- contingency planning; and
- risk management.

1.18 We interviewed staff from agencies that play a lead role in IT security across government and examined documents and files. In the four departments that we audited in 2002, we reviewed IT security practices in the five key areas noted above. We reviewed a Treasury Board Secretariat survey, conducted a survey of selected IT security practices in 82 government entities, and reviewed the results of technical tests conducted in a number of departments and agencies either by consultants or the Communications Security Establishment. In addition, we conducted our own technical tests. However, we did not examine the Secure Channel and national security matters.

1.19 More information about the follow-up objective, scope, approach, and criteria can be found at the end of the chapter in **About the Follow-Up**.

Observations and Recommendations

A revised Government Security Policy

1.20 The revised Government Security Policy has improved IT security across government, and support exists for further progress.

Roles and responsibilities of lead departments and agencies are outlined in the Policy

1.21 The Policy outlines the roles for the Treasury Board Secretariat and the 10 lead departments and agencies and divides responsibility for security among them. It eliminates duplication in the roles and responsibilities of the Royal Canadian Mounted Police (RCMP) and the Communications Security Establishment (CSE), and adds new roles for Public Safety and Emergency Preparedness Canada (formerly the Office of Critical Infrastructure Protection and Emergency Preparedness).

1.22 In 2002, it was too early to know whether the new roles and responsibilities were appropriate and would eliminate duplication. They are an improvement; the lead organizations, government, and agencies consult regularly on IT security. For example,

- the Information Technology Security Committee meets every two months and is co-chaired by the RCMP and the CSE;

- departmental security officers are briefed throughout the year by lead organizations; and
- senior IT and information management (IM) staff attend the Chief Information Officer Council, an advisory body that discusses IT and IM issues.

1.23 The Policy assigns the Treasury Board Secretariat the main responsibilities of co-ordination, leadership, oversight, and monitoring. However, the Secretariat is not adequately fulfilling its role of monitoring and overseeing the state of security in the government (see paragraphs 1.72 and 1.73).

Government-wide co-operation has improved

1.24 In 2002, we found that the Policy had not defined who was responsible for collecting and sharing best IT security practices across government. This has improved with various mechanisms that contribute to effective information sharing. These include courses organized by the RCMP and the CSE, liaison among chief information officers, and meetings of departmental security officers.

Several IT security standards remain to be developed

1.25 IT security standards stipulate what departments and agencies must do to meet the Policy's baseline requirements. They also promote consistency in security measures across departments and sharing of best practices.

1.26 In 2002, the Policy lacked the operational standards that departments and agencies must meet to comply with its various requirements. Since then, the Treasury Board Secretariat, in consultation with the lead security organizations and departments and agencies, developed the Management of Information Technology Security (MITS) standard, published in May 2004. The MITS standard offers guidance on maintaining secure IT systems in the following areas: management controls, risk assessments, dealing with security incidents and weaknesses in systems, auditing security, and business continuity planning. It also defines the roles and responsibilities of key security officers.

Business continuity plan—A plan for resuming essential business activities following the loss or serious deterioration of an organization's facilities or operations.

1.27 The MITS standard refers to a number of other standards that have not been completed (Exhibit 1.3). When these standards are completed, they, along with the MITS standard, should provide departments with the directives they need to comply with the Policy. The Treasury Board Secretariat has set December 2006 as the target date for complying with the MITS standard.

1.28 **Recommendation.** The Treasury Board Secretariat should complete all the security standards that support the Government Security Policy and the MITS standard. More specifically, it should

- prioritize the IT security standards that have been identified but not yet developed,
- prepare an action plan with timelines for each standard, and
- continuously identify IT security areas where standards are needed.

Treasury Board Secretariat's response. The Treasury Board Secretariat agrees. The MITS (Management of Information Technology Security) standard established an overarching set of baseline requirements for all departments and agencies. In conjunction with the lead security agencies (the Communications Security Establishment, Public Safety and Emergency Preparedness Canada, and the Royal Canadian Mounted Police), TBS will complete the Operational Security Standards before the end of 2006. More technical standards, as well as technical and operational guidance, will continue to be developed to meet the changing needs that reflect our dynamic risk environment.

TBS will develop, co-ordinate, and monitor a GoC-wide plan that will identify priorities among standards not yet developed. As well, a specific action plan for each standard will be produced by the appropriate lead agency and timelines agreed upon with TBS. This broad prioritization and planning in conjunction with the lead security agencies has already begun; the plan will be available to all departments and agencies on our Sitescape forum early in the fiscal year 2005–06.

Emerging IT security issues will continue to be identified by many sources, from lead security agencies and line department security professionals to the business and service delivery owners who have service and system needs to be met. While prioritizing these areas for standards development will be a collaborative effort, TBS will continue to play a GoC-wide co-ordination role, including oversight of the development and implementation of action plans to provide standards and guidance where needed.

Exhibit 1.3 Security standards yet to be completed

IT security standards

- Intrusion Detection
- Incident Management

Other security standards that affect IT security

- Security Training and Awareness
- Security in Contracting
- Identification and Categorization of Assets
- Threat and Risk Assessment
- Investigations and Sanctions
- Security Screening
- Departmental Security Program
- Protection of Employees
- Security Outside Canada
- Sharing of Information

Implementing the Policy

Major inconsistencies in compliance exist

1.29 We expected that departments would generally be complying with most of the Government Security Policy requirements. The core requirements of the Policy and standards have changed little since the mid-nineties. For over a decade, departments have been aware of the Policy and its requirement that their IT systems be adequately protected. However, we found that most departments are not complying fully with the Policy, and major inconsistencies in compliance exist. IT security practices vary in departments; examples are provided in special inserts throughout this section.

The security officer's place in the department

The Government Security Policy and the Management of Information Technology Security (MITS) standard require each department to define the roles of its security officers, in particular for IT security, and give them appropriate status in the organization. The extent that departments have met this requirement varies widely.

- At Industry Canada and Social Development Canada, the roles of the departmental security officer (DSO) and the IT security co-ordinator are clearly defined and follow the MITS standard. However, at Social Development Canada, there is no senior committee responsible for approving policies and standards, and making decisions about IT security. At Industry Canada, the DSO is not positioned strategically to provide strategic and decision-making advice to the organization. In addition, the IT security co-ordinator's function within the Chief Information Officer Branch, which controls only a fraction of the IT budget, does not have sufficient authority in the IT security decision-making process. Because of the limited scope of the two positions, the officers have little influence on department-wide security-related decisions, particularly IT security.
- At Fisheries and Oceans, the DSO does not occupy a position at a strategic level, as required by the Policy. An IT security co-ordinator position does exist and has a functional reporting relationship with the DSO. Given that the Department has many business sectors and regions and that communication between its two security officers is lacking, the Department is not able to develop and implement an integrated and well-co-ordinated security program.

1.30 The Policy requires departments to actively monitor their security programs and audit them. In 2003, the Chief Information Officer Branch of the Treasury Board Secretariat developed a self-assessment questionnaire that departments, in accordance with the MITS standard, must use annually to assess their IT security and security management practices. Departments answer questions about their security policies and practices, based on the Policy's baseline requirements, and are scored against a benchmark.

1.31 The questionnaire helps IT and security staff to better understand baseline IT security requirements, measure their current IT security capacity, and identify gaps between their current practices and best practices. The questionnaire also helps the Secretariat assess the effectiveness of the Policy and standards and assess whether departments are complying with their requirements.

1.32 By early 2004, the Secretariat was concerned that many departments were not implementing the current Policy's IT security requirements. In May 2004, using the questionnaire, the Secretariat surveyed more than

Complying with the Policy

Major inconsistencies in compliance exist

1.29 We expected that departments would generally be complying with most of the Government Security Policy requirements. The core requirements of the Policy and standards have changed little since the mid-nineties. For over a decade, departments have been aware of the Policy and its requirement that their IT systems be adequately protected. However, we found that most departments are not complying fully with the Policy, and major inconsistencies in compliance exist. IT security practices vary in departments; examples are provided in special inserts throughout this section.

The security officer's place in the department

The Government Security Policy and the Management of Information Technology Security (MITS) standard require each department to define the roles of its security officers, in particular for IT security, and give them appropriate status in the organization. The extent that departments have met this requirement varies widely.

- At Industry Canada and Social Development Canada, the roles of the departmental security officer (DSO) and the IT security co-ordinator are clearly defined and follow the MITS standard. However, at Social Development Canada, there is no senior committee responsible for approving policies and standards, and making decisions about IT security. At Industry Canada, the DSO is not positioned strategically to provide strategic and decision-making advice to the organization. In addition, the IT security co-ordinator's function within the Chief Information Officer Branch, which controls only a fraction of the IT budget, does not have sufficient authority in the IT security decision-making process. Because of the limited scope of the two positions, the officers have little influence on department-wide security-related decisions, particularly IT security.
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90 departments and agencies. Forty-six entities completed the questionnaire and shared their results with the Secretariat. The results indicate that the Secretariat's concerns were well founded. Of the 46 departments that responded, only 1 met all the baseline requirements of the Policy and standards.

1.33 Departmental IT security policies provide the foundation for meeting the Policy's standards for protecting information and information systems. The Secretariat's survey found that

- 16 percent of departments did not have an IT security policy;
- for those departments that did have one, 33 percent indicated that it had not been formally approved by management;
- 35 percent of departments did not have a policy requiring threat and risk assessments;
- 26 percent of departments did not have a policy requiring a business continuity plan for critical systems and services; and
- 12 percent of departments had not yet identified their critical systems.

Security policies in departments

In 2002, we noted that the four departments we had examined should update their security policies and implement a better governance framework for security. Since then, progress has been uneven:

- Industry Canada has made good progress in developing, implementing, and communicating its IT security policies. It has developed standards and guidance to address IT security issues.
- Senior management at Social Development Canada has yet to formally approve several policies on IT security. As a consequence, they are applied inconsistently across the Department.
- Fisheries and Oceans Canada has made progress in developing a security management framework and specific policies. However, none of these have been formally approved by senior management.
- The National Parole Board has recently started a project to review its IT security policies.

1.34 We developed a brief questionnaire that complemented the Secretariat's self-assessment questionnaire, and focussed on specific IT security practices in departments. We surveyed 82 entities and obtained a response rate of 100 percent. Our results corroborate the Secretariat's findings—major inconsistencies exist between the requirements of the Policy and standards, and the current practice of departments.

1.35 For several areas of security, compliance with the baseline requirements of the Policy and standards was significantly less than adequate. For example, although 65 percent of departments had business continuity plans, only 29 percent had tested them in the last two years.

1.36 The staff that we interviewed suggested various reasons for the gaps in IT security:

- a lack of money and people,
- a lack of interest in IT security by senior management, and
- IT security concerns were not part of the culture in their organizations.

1.37 A general lack of concern for IT security risks leaves systems vulnerable, where weaknesses could be exploited. As a result, sensitive data, including information on the privacy of Canadians, payroll and financial transactions, program information, and other mission-critical data are at increased risk of unauthorized disclosure, modification, or loss—possibly without being detected.

Fostering a culture of IT security in departments

Since we looked at the four departments in 2002, their success in promoting awareness of IT security issues and providing security training has been uneven.

Industry Canada has worked to raise awareness of IT security throughout the Department. It publishes security tips and monthly IT bulletins. It has also developed security training and a process for alerting staff to security incidents. The other departments have not been able to maintain awareness of security throughout the organization or have not been able to maintain the momentum.

1.38 **Recommendation.** The departments and agencies, subject to the Government Security Policy, should prepare an action plan indicating when they intend to fully comply with the IT security requirements of the Policy and with the Management of Information Technology Security standard. This IT security action plan should be approved by the deputy head or designate and reported to the Treasury Board Secretariat.

Treasury Board Secretariat's response. TBS agrees with this recommendation. Discussions have already begun with Information Technology Security Coordinators (ITSCs) to develop individual departmental plans for compliance with the IT security requirements of the Government Security Policy (GSP) and Management of Information Technology Security (MITS) standard. These departmental plans must be submitted to TBS by summer 2005, under the signature of the deputy head or designate, thus ensuring the involvement and commitment of senior departmental management.

1.39 **Recommendation.** The Treasury Board Secretariat should require all departments and agencies, subject to the Government Security Policy, to prepare timely IT security action plans, follow up on these plans shortly after December 2006, and report to the Secretary of the Treasury Board on the organizations that are not complying.

Treasury Board Secretariat's response. TBS agrees with this recommendation in line with recommendation 1.38. TBS will work with the departments and agencies in developing a common review and reporting process with a final report prepared for the Secretary of the Treasury Board in early 2007.

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IT security measures should reflect the level of risk

1.40 To protect government assets and information, the Policy follows a risk management approach—a set of practices and procedures to manage risks. Departments and agencies are required to comply with the baseline requirements of the Policy and its standards. In addition, departments are required to conduct a threat and risk assessment to determine whether they need safeguards above the baseline level. The MITS standard requires a threat and risk assessment for "every program, system or service." The assessment can be "simple or far more detailed and rigorous, depending on the sensitivity, criticality or complexity of the program, system or service." The requirement is not new; it was part of the 1994 Government Security Policy.

1.41 Allocating resources according to the degree of risk is a common IT security practice. As mentioned in our 2002 Report, "it is neither feasible nor cost-effective to eliminate all risks or threats to information assets. Moreover, like any priority, IT security has access to limited resources; risk assessments help direct resources to areas that warrant them."

1.42 We were expecting that, in complying with the long-standing requirement of the Policy and its standards, departments and agencies would have done threat and risk assessments to identify risks, and developed strategies for mitigating them.

1.43 In general, departments and agencies have yet to assess threats and risks adequately. Except in the departments where assessments are becoming well-established, they are done inconsistently or not at all. Out of 82 departments and agencies we surveyed, only 37 (45 percent) had performed threat and risk assessments of their programs, systems, or services, as required by the Policy and standards. In addition, only 28 departments had verified that recommendations made in their assessments had been addressed before putting the new programs and systems in place.

Certifying and accrediting systems in departments

The Government Security Policy and its related operational standards require that departments and agencies certify and accredit any new or modified system or application before it is used. Organizations must sign off on the system or application to certify that all the requirements of the risk assessments have been met.

Industry Canada is certifying and accrediting not only new systems and applications that it implements but also major changes to existing ones. Social Development Canada has developed a project life-cycle model that includes certifying and accrediting systems and applications under development. However, IT security is not always taken into consideration at the start of the project. In addition, the risk of failing to meet IT security requirements is increased because senior management, as the project review committee, has not met in over a year.

Fisheries and Oceans Canada and the National Parole Board have yet to comply with this requirement.

1.44 The reasons for not performing threat and risk assessments are unclear. The RCMP has been offering guidance and training for years on how to carry

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1.44 The reasons for not performing threat and risk assessments are unclear. The RCMP has been offering guidance and training for years on how to carry them out. In 2001, the Secretariat published the Integrated Risk Management Framework to provide departments with guidance on how to take a systematic approach to risk management. Over the last few years, the Communications Security Establishment has also developed methodology and guidance for doing comprehensive assessments. Yet, departments and agencies are not taking full advantage of this support to ensure that their IT resources are well protected in a cost-effective manner.

1.45 Departments and agencies that do not perform threat and risk assessments, as part of their business operations, do not know what risks they are exposed to. As a consequence, if departments and agencies do not consider their IT risks in their risk profile, they may not be directing their efforts and money on the most effective strategies to mitigate their exposure to IT risks, and may not be achieving their objectives.

Exposure—A function of the likelihood that a threat could occur, the consequences if it were to occur, and the safeguards in place.

1.46 **Recommendation.** Senior management in departments and agencies should ensure that IT security risks are included in preparing the corporate risk profile by identifying and assessing the key IT security risks and challenges and determining the level of risk to accept.

Treasury Board Secretariat's response. TBS concurs with this direction, which will encourage departments and agencies to develop an overall corporate risk profile that is reflective of the department as a whole, integrating all risk elements. Senior management oversight will be key to ensuring the success of this way forward. Also refer to recommendation and response 1.47.

1.47 **Recommendation.** The Treasury Board Secretariat should provide departments and agencies with guidance and tools for including IT security as a key component in their corporate risk profile.

Treasury Board Secretariat's response. TBS agrees with this recommendation, which is fundamental to departmental implementation of the Government Security Policy. TBS will work closely with lead security agencies, as well as with line departments, in developing the guidance and tools required to include IT security in an overall integrated corporate risk process, including an updated self-assessment tool.

A key part of this effort is the current project led by the CSE and the RCMP to amalgamate the Threat and Risk Assessment (TRA) guidelines from their respective organizations, thereby providing one common approach that will incorporate both physical and IT security TRA processes. As well, the Security Risk Management standard, planned for completion early in 2005–06, will provide an overall framework for incorporating security risk into the corporate risk profile.

Vulnerability assessment—A set of procedures to identify and assess weak spots in an organization's security architecture. It uses automated tools to identify if an organization has addressed, or remains exposed to, known security flaws and vulnerabilities in its computing environment.

Vulnerability assessments are important in assessing IT security

1.48 Many departments and agencies have carried out vulnerability assessments of their information systems. These assessments complement threat and risk assessments and are done to test systems for particular weaknesses that could compromise security. They do not determine whether the identified vulnerabilities could be exploited (another test, penetration testing, can determine that). They can be carried out from outside the security perimeter (externally) or within (internally).

1.49 Departments that perform regular assessments often identify weaknesses in networks that had previously been considered to be secure. This happens because new vulnerabilities are continuously being uncovered and exploited with malicious intent. Although many vulnerabilities come from outside an organization, most security incidents (willful or accidental) originate from inside an organization, where individuals have ready access to information and systems.

1.50 We reviewed a number of vulnerability assessments completed by external consultants, the Communications Security Establishment, and our Office (as part of this audit). Most of them revealed significant weaknesses that could be exploited. In some instances, the weaknesses had been exploited and gone undetected. There were also vulnerabilities that had existed for some time in the older versions of products. In such cases, the vulnerabilities cannot be rectified, and the products must be upgraded to ensure adequate protection.

1.51 Exhibit 1.4 shows that 46 departments and agencies (56 percent) from our survey have completed vulnerability assessments in the last two years. The other 36 departments (44 percent) had not completed an assessment in the last two years or had never completed one.

Exhibit 1.4 Organizations that have completed vulnerability assessments over the last two years

Size of organization*	Organizations surveyed	Those that completed one or more assessments	Percentage that completed assessments
Small (under 1,000)	54	27	50%
Medium (over 1,000 and under 10,000)	22	13	59%
Large (over 10,000)	6	6	100%
Total	**82**	**46**	**56%**

*Based on full-time equivalent staff

1.52 We found that the departments and agencies that completed recent assessments had been proactive; they had identified their IT security weaknesses and were prioritizing their efforts to correct those weaknesses. In paragraphs 1.53 to 1.59, we present some of the most important weaknesses reported in the assessments we reviewed. However, we intentionally do not disclose the departments and agencies involved or the exact weaknesses.

1.53 **Access to sensitive data and programs was not adequately controlled.** An important objective for organizations is to prevent unauthorized people from gaining access to data that support critical operations. Unauthorized access can lead to data being improperly modified, deleted, or disclosed. To effectively control access to data, organizations use software programs to monitor what information on the network is being accessed, and who is accessing it.

1.54 In many cases, the measures to control access to the systems and data were inadequate. We found that the risk associated with weak access controls increased because most organizations did not yet have a comprehensive program for monitoring who was accessing the network.

1.55 **Networks were not secure.** Networks are interconnected devices and software that allow individuals to share data and computer programs. Sensitive programs and data are stored and transmitted on networks. For this reason, networks must be made secure against unauthorized access, manipulation, and use by outsiders. Organizations can secure their networks by limiting the services that are available and installing devices that deny unauthorized requests for access to services and data.

1.56 In many cases, the networks of departments and agencies did not provide a secure operating environment. They used firewalls to protect internal networks from the Internet; however, their current network controls do not provide adequate protection from unauthorized access by outsiders. Without a secure network, departments and agencies are exposed to an increased risk that unauthorized individuals could gain access to sensitive data, and that service could be disrupted or denied.

1.57 **Inadequate network access controls.** Controls that limit access to a network ensure that only authorized individuals in an organization gain access to sensitive and critical data. Effective controls allow only authorized users to access the network from local and remote locations. They also provide safeguards to ensure that users cannot bypass them and cause the network to fail.

Testing for vulnerable passwords

Passwords are used to ensure that only authorized persons gain access to systems. If passwords are not sufficiently robust, they can be compromised by computer programs in what is known as "brute force attacks." Brute force attacks attempt to guess passwords. These attacks can quickly succeed with passwords that

- consist of only a few characters,
- are the same as the account name,
- use the default password,
- use a common word, or
- are derived from personal information that is readily available (such as a person's name, address, or favourite sports team).

Many of the vulnerability assessments that we reviewed found instances where passwords were susceptible to brute force attacks. Some of these vulnerable passwords were protecting access to sensitive entry points in mission critical systems.

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1.58 We found that many departments and agencies did not have secure controls in place. In many cases, the devices were not configured to consistently prevent unauthorized access to the systems on their networks.

Rights and permissions—The extent to which an individual or device can view, add, change or delete data on a computer system.

1.59 The Chief Information Officer Branch of the Secretariat has provided departments and agencies with guidance on how to mitigate potential vulnerabilities on network servers. However, we found weaknesses in areas such as managing passwords and assigning rights and permissions to users. For example, in some departments,

- default vendor accounts and passwords were still active;
- passwords were not set or not set properly;
- staff had broader access than needed; and
- dangerous services, such as remote execute commands, were available.

Testing for weaknesses in configuring systems

Vulnerability exists when an organization installs commercial off-the-shelf software or hardware and does not change the default settings. The default settings are often very permissive so that a new system can be set up easily. It is best practice to remove functions that are not used, and restrict access to a system administrator who, in turn, grants permissions to users to perform activities. The initial default settings that software and hardware vendors provide usually consist of an administrator account name, a standard set of privileges for the administrator, and a password. It is best practice to change these default settings before a new system component is put into use.

The vulnerability tests, performed by departments on their own systems, have identified instances where the manufacturer's default administrator settings had not been changed. Anyone who uses these default settings, to gain access to the system, with administrator privileges effectively has full control over granting access privileges for others and can modify or remove the functions the system performs. This situation presents a serious vulnerability.

Business continuity planning still needs improvement

1.60 The Government Security Policy requires departments to establish a business continuity planning program. The program ensures that all critical services continue to be available in the event of a major disruption, such as a prolonged power failure or natural disaster. Information technology is a major part of an organization's business continuity planning program.

1.61 Valuable information is obtained in business continuity planning from two activities:

- The business impact analysis identifies critical programs, systems, or services, and assigns priority to the ones that should be restored first, if they are disrupted.
- The threat and risk assessment identifies and categorizes information and related assets according to their sensitivity, assesses related threats and system vulnerabilities, determines the level of risk, and recommends safeguards that will reduce this risk to an acceptable level.

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1.62 Government operational standards require departments and agencies to perform both activities and, in particular, to carry out threat and risk assessments for every program, system, or service. The requirement to perform business impact analyses is new; we did not examine this area in our 2002 audit.

1.63 In 2002, we examined the business continuity planning program of four departments. None of the departments had updated its plans since preparing for Y2K or tested them periodically. Both activities represent best practices.

1.64 This audit looked at 82 departments and agencies. We examined how they were managing their business continuity planning program and whether the program meets the baseline requirements of the Policy and standards. We did not examine the adequacy of the plans or their tools—the business impact analysis and the threat and risk assessment. We found that several departments and agencies had made progress in instituting their business continuity planning program. However, based on our survey, progress has varied considerably among departments and agencies.

1.65 In our survey, we found that 53 departments (65 percent) had business continuity plans, but only 24 (29 percent) had tested them over the last two years. Periodic testing ensures that these plans remain effective.

1.66 The extent to which the four departments that we audited had updated and tested their business continuity plans and evaluated and mitigated the risks varied. Social Development Canada and Industry Canada had a good updating and testing regime, while the National Parole Board and Fisheries and Oceans Canada did not. Similarly, we found differences in the way departments had clarified roles and responsibilities for business continuity planning. As well, except for the National Parole Board, the other departments had developed improved decision-making mechanisms for developing and implementing their business continuity planning program.

Some departments have yet to start monitoring their security

1.67 The Government Security Policy requires departments to continuously monitor their security program, audit it, and report the findings to the Treasury Board Secretariat. The requirements for ongoing monitoring and periodic reporting provide management with information on whether measures to protect the security of IT systems are adequate and appropriate.

1.68 Prior to 2002, the Policy required departments and agencies to audit their IT security at least every five years. In 2002, we observed that, of some 90 departments and agencies subject to the Policy, only 10 had submitted internal audit reports. Most departments (almost 90 percent) had not complied with the Policy requirement.

1.69 The revised Policy continues to require departments and agencies to monitor their security programs. However, they are no longer required to audit their programs at least once every five years. It is now up to departments to decide how often they will audit their programs, as part of their overall planning process.

1.70 Consequently, we were concerned that departments and agencies would not periodically audit their IT security practices. However, we noted some improvement in this area. Thirty-seven departments and agencies (45 percent) that we surveyed had audited their IT security program in the last two years (as opposed to 10 percent in 2002).

Monitoring security practices in departments

In the four departments we examined, practices for monitoring IT security varied from unsatisfactory to non-existent. We also found that when departments carry out IT security reviews, they do not always correct the problems they have identified. These reviews often revealed a lack of compliance with basic security requirements, such as instituting strong passwords and correcting weaknesses that have been identified.

For example, Social Development Canada has a new process to monitor and respond to IT security incidents, as required by the Policy. However, the Department has not defined what constitutes an IT security incident. This prevents consistent reporting and analysis of incidents, and consistent enforcement of the policies and standards.

1.71 **Recommendation.** Departments and agencies, subject to the Government Security Policy, should provide the Treasury Board Secretariat with an annual schedule of their planned IT security monitoring activities, including self-assessments, vulnerability assessments, and internal audits. They should also provide the Secretariat with a copy of internal audit reports, within three months of completing them.

Treasury Board Secretariat's response. The Internal Audit Policy requires departments to have at least an annual internal audit plan, which must be copied to TBS. This Policy also requires deputy heads to ensure that copies of completed audit reports are provided in a timely manner to the Treasury Board Secretariat. According to the Government Security Policy, the results of internal audits must be reported to the TBS.

TBS agrees with this recommendation, which will require departments and agencies to submit an annual schedule of IT security monitoring activities. Review of these schedules by TBS will provide a level of assurance that departments and agencies are performing ongoing monitoring of their departmental ITS activities and ensure that TBS does receive internal audit reports in a timely fashion.

The Secretariat's oversight of the Policy

1.72 The Treasury Board Secretariat has no formal process in place for getting departments and agencies to submit their audit reports or analyzing the security findings of these reports. Since 2002, the Secretariat has received only 10 audit reports on IT security and has not issued a mid-term report, as required by the Government Security Policy. Internal audit reports can be an important element in developing an overall picture of IT security in departments and agencies.

1.73 The revised Policy requires the Secretariat, as part of its overall monitoring, to submit a report to the Treasury Board on how effective the Policy is in strengthening security. The report was due in the summer of 2004

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1.73 The revised Policy requires the Secretariat, as part of its overall monitoring, to submit a report to the Treasury Board on how effective the Policy is in strengthening security. The report was due in the summer of 2004 but has not been produced. As a result, little baseline information exists on the state of IT security across the government.

1.74 **Recommendation.** The Treasury Board Secretariat should monitor departments to determine whether they are carrying out timely audits and other IT security monitoring activities.

Treasury Board Secretariat's response. TBS agrees with this recommendation and will work collaboratively with the lead security agencies and departmental representatives to develop a monitoring process that meets this recommendation and provides adequate information.

TBS will find the most effective way to collect the information required for this monitoring by reusing information that departments and agencies are currently providing and requesting only supplemental information as necessary.

1.75 **Recommendation.** The Treasury Board Secretariat should complete the mid-term report on the effectiveness of the Government Security Policy in a timely manner, as required by the Policy.

Treasury Board Secretariat's response. The mid-term report is scheduled to be presented to the Treasury Board in early 2005.

Conclusion

1.76 Overall, the government has made unsatisfactory progress in strengthening information technology security since our audit in 2002.

1.77 The government has made good progress in several areas that we had previously raised concerns about. The 2002 Policy clarified the roles and responsibilities of the various players in IT security. Since then, lead organizations have consulted regularly and are co-operating to develop standards to strengthen IT security practices. The Policy lacked operational standards for departments to meet its various requirements. Since then, the Management of Information Technology Security standard has been developed, along with some other associated standards.

1.78 However, a number of IT security standards remain to be developed and the Secretariat has not completed its mid-term evaluation of the effectiveness of the Policy. Business continuity planning still needs improvement, and most departments and agencies have yet to assess threats and risks adequately.

1.79 Since 2002, the use of the Internet has increased, and portable computer devices and wireless technologies have made access to information easy and affordable. Government systems are more connected, and the government is aiming for greater inter-operability and integration of its business processes. This environment provides more opportunities for problems to occur, such as theft of data, malicious attacks, or criminal actions. The threats have increased significantly since 2002, and they can cause serious damage to an organization.

1.80 Despite a stronger Policy, new standards, and other examples of progress, the government still needs to address serious weaknesses in IT security. The majority of departments and agencies are not complying with the baseline requirements of the Policy and the associated standards.

1.81 A lack of compliance with the Policy and standards, a lack of awareness of IT security risks, and a lack of understanding how breaches of IT security could affect operations have broad implications. The risk of security breaches that could violate the privacy of Canadians increases. These violations could cause hardship to individuals and erode the trust that Canadians have in the ability of their government to transact business on-line, in a secure and confidential environment.

Government's overall response. Treasury Board Secretariat (TBS) offers the following information to better explain the context within which TBS and the Government of Canada (GoC) departments and agencies are working.

The GoC operates in a dynamically changing risk environment that requires an active and continuous defence against cyber attacks, viruses, and other internet-related threats. While policy and standards are necessary to establish a common posture and constitute one of the key components of the overall federal ITS response, TBS and the three lead security agencies (namely the Communications Security Establishment (CSE), Public Safety and Emergency Preparedness Canada (PSEPC), and Royal Canadian Mounted Police (RCMP)) are also providing practical assistance and guidance to departments and agencies to help them improve their overall Information Technology Security (ITS) posture and to support their ability to act quickly and co-operatively to prevent, detect, and respond to security breaches across the GoC. Like all large and geographically diverse organizations, the dependence of the GoC on a networked and interdependent environment continues to grow. Such an environment will increasingly require a "collective" approach to effective IT security, wherein a department's ability to respond rapidly to a security incident and share information about it will become the hallmark of an enhanced security organization in the 21st century.

There is a growing requirement for individual departments and agencies, as well as the GoC at large, to be more resilient in the face of rapid technological change. This will require the engagement and co-operation of personnel across organizational boundaries, sharing information on incidents, issues, and solutions.

TBS and PWGSC, in conjunction with the lead security agencies, are also leading the move toward the provision and use of common and shared IT security infrastructures and services. Measures such as Intrusion Detection (ID), Vulnerability Assessment (VA), software maintenance, and system development methodologies are more efficiently implemented in a common centrally managed IT infrastructure rather than department-by-department solutions. The significant investments made by the GoC in common IT services are an important contribution to more effective security for the GoC's operations and services.

The Secure Channel provides a set of common and secure infrastructure services protecting the delivery of information and transactions for individuals, businesses, employees, and other governments. At this time, 122 departments and agencies are using one or more of the Secure Channel service offerings in support of their on-line service and information delivery. Building and maintaining the trust and confidence of our citizens, businesses, and other governments with whom we do business is fundamental to effective service delivery.

With the publication of the National Security Policy (NSP) in 2004 and the development of processes, committees, and organizational structures to meet the objectives of that Policy, TBS will ensure that departments and agencies follow a strategy that supports the integration and co-ordination of plans, activities, infrastructures, and operations. To this end, projects that enable the pro-active sharing of information and processes both within the GoC and across jurisdictions will be key to this integration.

About the Follow-Up

Objective

The objective of this follow-up was to determine whether the Treasury Board Secretariat and departments had implemented the recommendations we made in Chapter 3 of our 2002 Report. We assessed whether, in general, departments and agencies had implemented IT security baseline requirements to protect information technology assets and deliver services securely and without interruption.

Scope and approach

Our audit focussed on two levels:

- **Lead security agency level**. We focussed on the Treasury Board Secretariat, which provides co-ordination, leadership and oversight for IT security. We also met staff from the Royal Canadian Mounted Police, Public Safety and Emergency Preparedness Canada, the Communications Security Establishment, and the Canadian Security Intelligence Services.
- **Departmental level**. We reviewed selected security practices in the four departments we had examined in 2002: Fisheries and Oceans Canada, Social Development Canada (formerly Human Resources Development Canada), Industry Canada, and the National Parole Board.

We looked at the results of a self-assessment questionnaire that the Secretariat conducted in 97 departments and agencies. The self-assessment was voluntary; only 46 departments and agencies responded. The responses were not corroborated with evidence. We complemented the Treasury Board Secretariat survey with a survey of 82 departments and agencies on specific security practices. We obtained a 100 percent response rate and, to validate the answers, we corroborated the positive answers in a random sample of 20 departments and agencies.

We assessed the safeguards that departments and agencies use to ensure the security of government assets and information. We reviewed the results of vulnerability assessments and technical tests done by consultants, the Communications Security Establishment, and our Office (for three departments) as part of this audit. We ensured that our technical tests did not harm the systems we tested or the data they contained.

We looked at the extent to which the following areas of IT security had improved:

- co-operation and information-sharing among lead organizations on IT security,
- development and implementation of IT security standards to support policy,
- effectiveness of the Government Security Policy and existing security measures,
- contingency planning, and
- risk management.

We did not examine the Secure Channel as, at the time of the audit, it had not yet received effective project approval by the Treasury Board. We did not examine national security matters, which will be the subject of a separate audit on national security enhancement initiatives to be reported in 2005.

Criteria

As in our 2002 audit, we expected that

- the framework for IT security ensures that IT assets and information are protected and supports the secure and uninterrupted delivery of government services;
- the governance structure for IT security ensures strong leadership and support from the central and lead agencies, and consistent, cost-effective IT security practices across government;

- policies, standards, and practices are commensurate with the current state of risks and threats to IT security;
- consistent with assessed risks and current security requirements, departmental measures and processes prevent, detect, and respond to IT threats; and
- IT security practices are monitored and periodically reassessed, and vulnerabilities are addressed.

In addition, we expected that new IT security risks are identified and addressed.

Audit team

Assistant Auditor General: Douglas G. Timmins
Principal: Richard Brisebois
Directors: Greg Boyd, Tony Brigandi, Guy Dumas

Bernard Battistin
Etienne Robillard

For information, please contact Communications at (613) 995-3708 or 1-888-761-5953 (toll-free).

Chapter

2

Transport Canada

Overseeing the National Airports System

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Transport Canada

Overseeing the National Airports System

Main Points

2.1 Transport Canada has made satisfactory progress in implementing the recommendations of our 2000 audit.

2.2 Transport Canada has almost concluded the National Airports Rent Policy Review, which will allow it to assess the financial impact of the transfer of the airports in the National Airports System (NAS). The review will determine, among other things, the impact that rent charges have on the viability of the airport authorities and air carriers, and on the government's finances. It will also determine whether the current rent policy is fair to the taxpayers, users, and airport authorities.

2.3 The Department has also clarified and assumed its role as owner, landlord, and overseer of the NAS airports, and established good relations with the airport authorities. The Department found a high level of compliance by airport authorities with the provisions of their lease. The authorities are maintaining the airport facilities in as good or better condition than before the transfer. Also, they are exercising due diligence regarding environmental protection and complying with the lease provisions on public interest and governance.

2.4 Moreover, Transport Canada now monitors the financial situation of the airport authorities annually and oversees the long-term viability of the NAS.

2.5 However, Transport Canada has not kept to the schedule it set for the National Airports Rent Policy Review. The review began in 2001 and was to be completed in fall 2002; it is still in progress. Department officials are aware that the delay could have potentially significant financial impacts on some of the airport authorities.

2.6 Transport Canada does not measure the airports' performance, with the exception of financial data. The Department has not yet identified the areas it needs to measure and has no approved framework showing how it would measure performance.

Background and other observations

2.7 In 1992, Transport Canada began to transfer the major Canadian airports. By March 2003, the 26 NAS airports had been transferred: twenty-two to airport authorities, three to territorial governments, and one to a municipality. Transport Canada retained ownership of the airports transferred to airport authorities in order to guarantee the long-term viability of the NAS. The transfer of the airports to the airport authorities, not-for-profit organizations, was set up as a 60-year lease.

2.8 In our October 2000 Report, Chapter 10, we found that Transport Canada did not know the financial impact of the transfer of the NAS airports. It had not defined its role as owner, landlord, and overseer of the airports; did not know whether the airport authorities were complying with the provisions of their lease; and was not systematically overseeing the financial viability of the NAS.

Transport Canada has responded. The Department agrees with our recommendations and has indicated the actions it plans or has under way to address them.

Introduction

Transport Canada has commercialized the airports in the National Airports System

2.9 In the late 1980s, the federal government started commercializing its air transportation assets. For example, in 1988 Transport Canada privatized Air Canada. These measures were part of a general movement by the federal government to commercialize the transportation infrastructures and enterprises that it operated. In 1992 Transport Canada transferred five of Canada's largest airports to local interests.

The National Airports System

The National Airports System includes the airports that Transport Canada considers "essential to Canada's domestic prosperity and international competitiveness." They are all the airports that, in 1994, handled at least 200,000 passengers and those that are in the national, provincial, and territorial capitals. In 2003, these 26 airports handled 92 percent of Canada's air passengers.

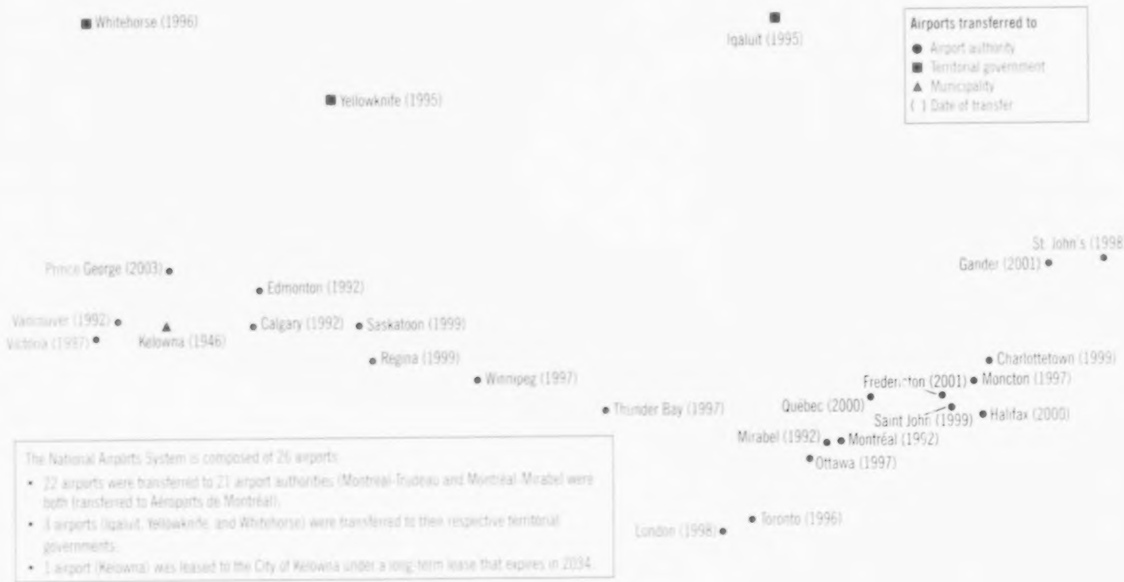
2.10 At the time, the only guidance on the airport transfers was a series of guiding principles, approved by Cabinet starting in 1987, and the 1992 *Airport Transfer (Miscellaneous Matters) Act*, which addressed some transfer issues. The 1994 National Airports Policy defined the government's objectives and role for the airports and allowed it to establish the National Airports System (NAS) and a framework for creating and operating Canadian airport authorities.

2.11 One of the key objectives of the Policy was "to ensure a safe, secure and viable National Airports System that will serve Canada in the 21st century." According to the government "local operation and commercialization of the airports will promote cost-efficiency and the provision of services matched to user needs."

2.12 By the end of March 2003, all 26 NAS airports had been transferred. Twenty-two were transferred to airport authorities, three to territorial governments, and one to a municipality (exhibits 2.1 and 2.2).

2.13 Transport Canada retained ownership of the airports transferred to airport authorities in order to guarantee the long-term viability of the NAS. The transfer to airport authorities, not-for-profit organizations, was set up as a 60-year lease with an option to renew for 20 more years. If the airport authorities and Transport Canada do not reach an agreement by the end of the lease, the airports and all the improvements since their transfer revert back to the federal government, free from any financial obligation.

Exhibit 2.1 Canada's National Airports System

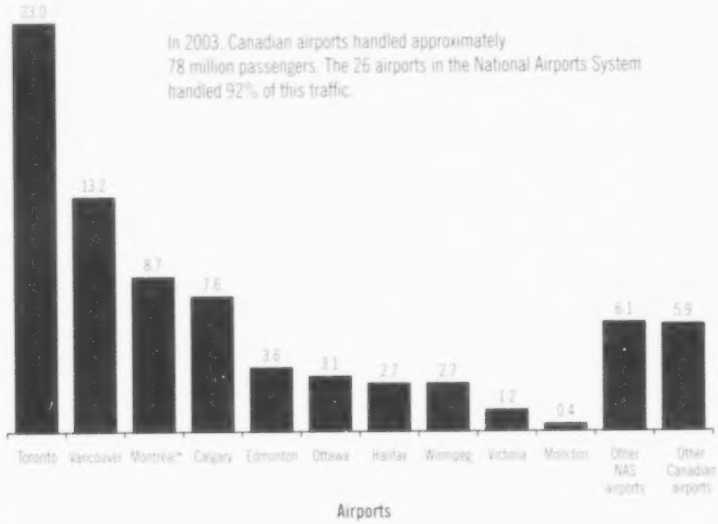

Whitehorse (1996)
Iqaluit (1995)
Yellowknife (1995)
Airports transferred to
● Airport authority
■ Territorial government
▲ Municipality
( ) Date of transfer
St. John's (1998)
Gander (2001)
Prince George (2003)
Edmonton (1992)
Vancouver (1992)
Victoria (1997)
Kelowna (1946)
Calgary (1992)
Saskatoon (1999)
Regina (1999)
Winnipeg (1997)
Charlottetown (1999)
Fredericton (2001)
Moncton (1997)
Québec (2000)
Thunder Bay (1997)
Saint John (1999)
Halifax (2000)
Mirabel (1992)
Montréal (1992)
Ottawa (1997)
London (1998)
Toronto (1996)

The National Airports System is composed of 26 airports:

- 22 airports were transferred to 21 airport authorities (Montréal-Trudeau and Montréal-Mirabel were both transferred to Aéroports de Montréal).
- 3 airports (Iqaluit, Yellowknife, and Whitehorse) were transferred to their respective territorial governments.
- 1 airport (Kelowna) was leased to the City of Kelowna under a long-term lease that expires in 2034.

Source: Transport Canada, August 2004

Exhibit 2.2 Air passenger traffic in Canada, 2003 (millions of enplanned and deplanned passengers)



In 2003, Canadian airports handled approximately 78 million passengers. The 26 airports in the National Airports System handled 92% of this traffic.

* Includes Montréal-Trudeau and Montréal-Mirabel airports, which are under the jurisdiction of Aéroports de Montréal.

Source: Statistics Canada

What we found in 2000

2.14 In our October 2000 Report, Chapter 10, we audited the transfer of the airports in the National Airports System by Transport Canada. We found that the Department

- did not know the financial impact of the transfer. Specifically how the transfer affected taxpayers and the long-term viability of the airport authorities, or whether it was fair and equitable for all airports. The Department had not completed its five-year review of the transfer of the first five airports.
- had not defined its role as owner, landlord, and overseer of the airports.
- did not know whether airport authorities were complying with the provisions of their lease in areas such as facility management, environmental protection, and governance.
- was not systematically overseeing the financial viability of the NAS.
- had not determined how to measure the performance of the airports.
- had not reported to Parliament on the impact of the transfer.

Events since 2000

Did you know?

The first Canadian airport to receive its designation as an international airport in 1928:
Winnipeg Airport

2.15 In November 2001 the Standing Committee on Public Accounts held a hearing on Chapter 10 of our October 2000 Report and produced *Report 21*, which set out its findings and recommendations. Transport Canada responded to the report in October 2002.

2.16 Transport Canada completed the five-year review of the transfer of the first five airports and undertook two major projects. One was to draft legislation on airports and the other was to review the airports rent policy.

- Bill C-27 proposed an economic and governance framework for airport authorities. The Bill was first read in 2003 but died on the order paper at the end of the parliamentary session. The Department plans to revisit the legislation, discuss it with stakeholders, and table it in Parliament, but it has not yet determined when.
- The National Airports Rent Policy Review is examining whether the current policy is fair to taxpayers, the airport authorities, and users and the impact the policy has on the long-term viability of the airports and air carriers. At the time of our audit, the results of the review had still not been presented to Cabinet.

Focus of the follow-up

2.17 This follow-up examined whether Transport Canada implemented our 2000 recommendations on the transfer of the airports in the National Airports System (see paragraph 2.14 for the six observations). More details on the objective, scope, and criteria can be found in **About the Follow-Up**.

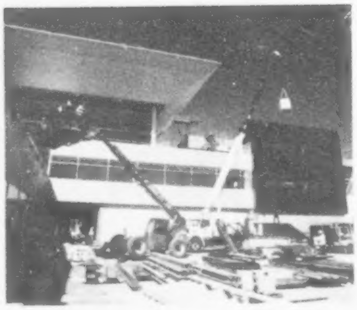
Observations and Recommendations

Impact of the transfer of airports

Transport Canada has completed its five-year review of the transfer of the first five airports

2.18 In 2000 we recommended that Transport Canada urgently complete the five-year review that it was to conduct in 1997, at the request of the Treasury Board, and report the results to decision makers and stakeholders. The review was to

- determine the impact of the transfer of the first five airports (Vancouver, Edmonton, Calgary, Montréal-Trudeau, and Montréal-Mirabel), including the financial impact on the federal government and in particular Transport Canada; and
- present recommendations on a framework to govern the long-term relationship between Transport Canada and the NAS airports.



Construction work at Pierre Elliott Trudeau International Airport in Montréal

Source: Aéroports de Montréal

2.19 Transport Canada tabled its final report on the five-year review in 2002, which included all but one of the requirements.

- The Department determined the impact of the transfer, in particular, on service levels and security, and the financial impact on the government.
- It presented recommendations on a governance framework to adopt.
- However, although Transport Canada estimated the impact of the transfer on its budget, it did not include this information in its report.

The review also looked at issues beyond its requirements, most notably, issues on airport authority governance.

2.20 The Department concluded that the NAS was a success and that the five airports were being operated well. It did, however, note that a number of issues had emerged, in particular the need for airport authorities to be more transparent and accountable and to improve their pricing practices.

New terminal at the Greater Moncton International Airport

In 2003, the Moncton Airport had the largest percentage increase in passenger volume of all NAS airports.

Source: Moncton Airport Authority and Statistics Canada

Transport Canada has almost completed its assessment of the financial impact of the transfer, but it has not kept to its schedule

2.21 In 2000, we found that Transport Canada did not know the financial impact of the transfer of airports in the National Airports System. Specifically how the transfer affected taxpayers and the long-term viability of the airport authorities, or whether it was fair and equitable for all airports.

2.22 **Review of the National Airports Rent Policy.** One of the main decisions to come out of the five-year review of the transfer of the first five airports was to review the National Airports Rent Policy. The review focusses on the 22 airports transferred to airport authorities and will determine, among other things,

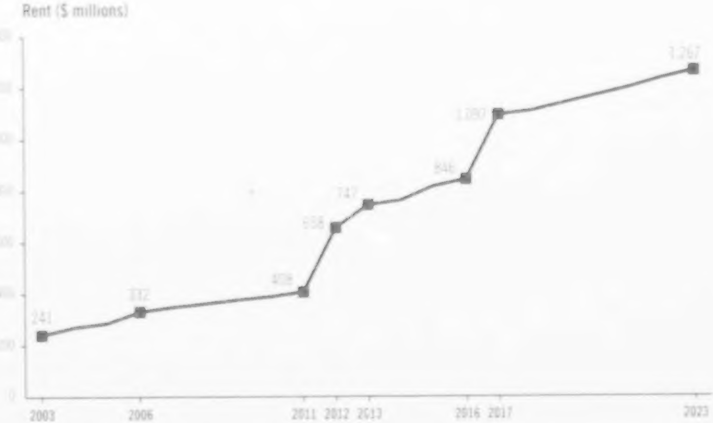
- what impact the policy has on the financial viability of airport authorities and air carriers;
- whether the current policy is fair to taxpayers, airport authorities, and users;

- whether the rents payable over the life of the lease provide fair value to the government for the transfer of the airports; and
- what impact the policy has on the competitiveness of the air transportation system.

The review will determine whether the rent policy needs to be changed.

2.23 The Department is completing its assessment of the impact that rent has on the financial viability of the airport authorities and air carriers, one of the key objectives of the review. Rent is a significant percentage of revenue for many airport authorities. In 2003, the Vancouver, Toronto, Calgary, and Ottawa airport authorities paid Transport Canada 19 to 24 percent of their operating revenues in rent. Also in 2003, all the NAS airports paid $241 million in rent. According to the current policy, airport authorities will pay over $1 billion annually in rent starting in 2017 (Exhibit 2.3).

Exhibit 2.3 Rent that airport authorities will pay Transport Canada from 2003 to 2023, under the current rent policy



The significant increase in rent in 2012, 2013, and 2017 is due to a "participation rent," which is added to the rent paid starting in 2012.

Source: Transport Canada

2.24 If the review leads Transport Canada to recommend reducing the rent, it intends to see that an appropriate share of the savings is passed on to the air carriers. The airport authorities have already informed the Department that they agree in principle.

2.25 Another important objective of the review is to determine whether the current rent policy gives the government fair value for the transfer of the airports. Following recommendations from the rent review advisory committee, the Department has separated calculating the value of the airports from determining how much rent to charge. The Department intends to set rents that are fair to taxpayers, airport authorities, and users.

To achieve this goal, it analyzed airport divestitures in the United Kingdom, Australia, New Zealand, and the United States. It also compared the return on investment for its airport leases with the return that regulated industries received—industries like rail transportation, telecommunications, petroleum products transportation, and electricity.

2.26 **Appropriate review procedures.** We feel that the work under way is satisfactory and that the Department has put in place procedures for reviewing the rent policy that take into account its complexity. Before setting the terms of reference for the review in 2002, the Department consulted with stakeholders and took their feedback into account. However, it has not consulted them since that time. We encourage Transport Canada to consult stakeholders on relevant elements of the options under study and keep them up to date from time to time, especially when deadlines need to be changed.

Investing in airports

According to Transport Canada

- the Department invested around $1.1 billion in the airports in the National Airports System when it operated them from 1983 to 1992
- airport authorities invested $6.6 billion from 1999 to 2003

2.27 Before undertaking any necessary studies, the Department made sure that the objectives of the review could be met. It also took into account the objectives when it analyzed different rent-setting formulas. The Department feels that the formula it chooses must be responsive to market changes in air transportation, easy to administer, and fair to all airport authorities.

2.28 For the review, the Department hired consulting firms to assist with technical analyses and financial projections. The Department used proper procedures to select the firms; it assigned work according to technical expertise and in a way that prevented any conflict of interest.

2.29 The Department created an advisory committee made up of representatives from Transport Canada, the Treasury Board Secretariat, the Privy Council Office, the Department of Finance Canada, and the consulting firms hired for the review. In addition to providing a forum for discussion, the committee gives advice and makes recommendations on the consulting firms' technical studies. It has validated key assumptions made in the studies.

2.30 The Department meets regularly with the central agencies. It shares the results of its technical analyses, explains its positions, and gets the agencies' feedback.

2.31 **The Department has not kept to its original schedule.** The review, which began in 2001, was scheduled to be finished in fall 2002 and then in fall 2003. At the time of our audit, the results of the review had still not been presented to Cabinet. Transport Canada attributes the delays to the complexity of the review process and to a series of external events—September 11, the war in Iraq, the SARS crisis, bankruptcy of Canada 3000, and Air Canada placed under the protection of the *Companies' Creditors Arrangement Act*. These events had serious consequences for air transportation and created extra work for the review team.

2.32 Department officials are aware that the delays could have potentially significant financial consequences for some airport authorities. For example, the credit bureaus that establish ratings of the airport authorities take into account the lease conditions with Transport Canada.

The overall impact of the transfer has yet to be assessed

2.33 Transport Canada prepared a framework, as early as 1999, for evaluating the National Airports System. The framework described how the Department proposed to assess the overall impact of the transfer of the NAS airports—not only the financial impact but also the consequences on service and security.

2.34 We noted that the framework is of a good quality, clear, and logical. However, the evaluation has been postponed more than once. The Department wants to begin its evaluation once the proposed legislation on airports has been adopted by Parliament and the review of the National Airports Rent Policy has been completed; we consider this an acceptable approach. The Department intends to update the framework so that the next evaluation focusses on the impacts of these initiatives on NAS airports.

A new role for Transport Canada

Transport Canada has clarified its role for the National Airports System

2.35 In our 2000 audit, we were concerned that Transport Canada had yet to clearly define its role and responsibilities as owner, landlord, and overseer of the National Airports System.

2.36 We found that Transport Canada has since clarified the role it intends to play:

- monitoring the operation of the NAS,
- protecting federal property leased to airport authorities, and
- promoting good governance by airport authorities.

This role was defined in the proposed legislation on airports.

2.37 The Department has clearly communicated its role and responsibilities to the airport authorities, and airport executives understand the Department's responsibilities well. Also, Department staff clearly understand Transport Canada's role and responsibilities.

Transport Canada has established good relations with the airport authorities

2.38 In order to carry out its responsibilities properly, especially in overseeing the airport authorities, Transport Canada needed to establish good relations with the airport authorities. The airport executives that we interviewed confirmed that they enjoy good relations with Transport Canada managers and staff.

The draft legislation on airports was not adopted

2.39 The proposed legislation on airports was drafted by Transport Canada in response to its five-year review. The legislation proposed a framework for the economic activities of the airport authorities and for governance. It addressed a number of issues that the five-year review and our 2000 audit had raised (Exhibit 2.4). We found that the legislation included most features of a governance framework.

2.40 The draft legislation had its first reading in 2003 but died on the order paper at the end of the parliamentary session. Although the leases incorporate a number of features of a governance framework (see Exhibit 2.4), other features, such as a process for resolving disagreements about airport fees between airport authorities and air carriers, are still missing. The Department plans to revisit the legislation, discuss it with stakeholders, and table it in Parliament at an undetermined time.

Exhibit 2.4 The proposed 2003 *Canada Airports Act* addressed most of the governance issues that the five-year review and our 2000 audit had raised

Some of the features of a governance framework	Five-year review of the transfer of the first five airports	Our 2000 audit	Proposed 2003 *Canada Airports Act*	Airport authorities' ground lease
Clear definition of federal roles and responsibilities	●	●	●	●
Consultation, transparency, and access to information on airport authorities	●	●	●	●
Airport authorities' audited financial statements included in their annual reports		●	●	●
Five-year performance reviews of airport authorities conducted by independent consultants	●	●	●	●
Framework for determining airport fees	●	●	●	
Process for resolving disagreements over airport fees	●	●	●	
Framework for subsidiaries of airport authorities	●	●	●	
Disclosure of major contracts not awarded under a public bid		●	●	●

Lease monitoring

The lease monitoring program is firmly in place

2.41 The ground lease is the main tool that defines the obligations of Transport Canada and the airport authorities. It contains provisions that airport authorities must follow, in areas such as governance and public interest, the environment, safety and security, and facility management.

Good practice

For the past few years, the Greater Toronto Airports Authority and Aéroports de Montréal have been certified ISO 14001, which is an internationally recognized standard for environmental management.

2.42 The lease stipulates that Transport Canada can audit the airport authorities without restrictions. In 2000, we found that the Department had not exercised this right and did not know to what extent the authorities were complying with key provisions in their lease. Therefore, it was not able to report to Parliament on this matter.

2.43 Since then, the Department has developed a rigorous lease monitoring program that assesses the airport authorities' compliance with their lease provisions.

2.44 At the time of our audit, the Department had conducted three annual assessments and was in the process of conducting a fourth for 2004. Ottawa headquarters provides support to the regional offices, especially with interpreting the lease provisions to ensure that they are applied equally across Canada. The regional offices carry out the lease monitoring program. The Department assesses the airport authorities' compliance with each clause of the lease (Exhibit 2.5). The annual assessments mean that concerns raised by each party can be dealt with promptly.

Good practice

To familiarize staff at Transport Canada's headquarters on issues that airport authorities face, the Ottawa Airport Authority offered training on, among other things, governance, how to plan an airport expansion project, and how airlines view airports.

2.45 When we visited the regional offices, staff told us that they were satisfied with support from headquarters. For instance, headquarters developed

- a comprehensive training plan that covers most aspects of lease monitoring—staff were satisfied with the training and found the topics relevant; and
- in collaboration with the regions, a procedures manual and checklists that facilitate monitoring.

2.46 The five regional offices responsible for lease monitoring must produce a report for each airport authority they cover. Monitoring includes reviewing documents, attending public meetings, and visiting the airports. We found that the information collected by the regional offices supports the observations made in the reports. Overall, the files we examined were complete and the documentation was adequate.

Exhibit 2.5 Sample clauses in the ground lease of airport authorities

Governance and public interest

The airport authority shall hold an annual public meeting on the management of the airport and give prior notice of the meeting at least 30 days in advance.

The airport authority shall publish an annual report including its audited financial statements.

The airport authority shall list in its annual report all contracts over $75,000 that were not awarded under a public bid solicitation process.

Environment

The airport authority shall adopt an Environmental Management Plan and update it as the need arises.

Safety and security

The airport authority shall comply with federal safety and security regulations.

Facilities

The airport authority shall, at a minimum, undertake to ensure adherence to the National Building Code and the National Fire Code during all construction work.

Plans and future infrastructure

The airport authority shall adopt an Airport Master Plan and a Land Use Plan.

Transport Canada has found the right balance in how it manages the lease monitoring program

2.47 In our 2000 report, we noted that the Department had adopted a hands-off approach as landlord and overseer of the NAS. Since that time, while recognizing that the management and operation of the airports fall exclusively within the airport authorities' jurisdiction, the Department clearly indicated that it intends to assess the authority's compliance with their lease. The Department has found the right balance between a passive approach and interfering in the airports' activities; it exercises due diligence and tries to minimize the impact its monitoring has on the authorities.

2.48 The Department's approach, however, does not systematically address the risks of non-compliance with the lease. Department employees tend to conduct informal risk analyses. This approach may work when the employees who participate in the lease monitoring are knowledgeable and very experienced, which is generally the case. However, Transport Canada officials are aware of the merits of a more systematic approach to risk management and lease monitoring. The Department is currently working on such an approach, which could help employees, especially those with less experience, identify provisions of the lease that need closer scrutiny.

Environmental monitoring by airport authorities

Air quality monitoring near Toronto's Pearson International Airport

Source: Greater Toronto Airports Authority

Noise monitoring near Calgary International Airport

In 2002–03, the Calgary Airport Authority hired a consultant to determine whether its operations were in compliance with environmental regulations and its own environmental management system.

Source: Calgary Airport Authority

Transport Canada has noted a high level of compliance among the airport authorities with their lease provisions

2.49 With its lease monitoring program, the Department is now able to assess the extent to which airport authorities comply with the provisions of their lease. The Department noted that the airport authorities comply with all the key provisions. In its national summary report for 2003, Transport Canada concluded that the airport authorities are

- maintaining the airport facilities in as good or better condition than before the transfer;
- exercising due diligence with regard to environmental protection;
- complying with lease provisions on public interest and governance—they are holding annual general meetings, producing annual reports, and preparing five-year performance reviews; and
- aware of safety and security, and comply with all the regulations and standards applicable to their certification.

Transport Canada did not find any situations of non-compliance that would have forced it to serve a default notice on any of the airport authorities.

Overseeing the financial viability of the airports

Transport Canada is overseeing the financial viability of the NAS

2.50 In 2000, we observed that Transport Canada was not systematically overseeing the financial viability of the NAS. The National Airports Policy states that "by retaining legal ownership of NAS airports, the federal government will be able to guarantee the integrity and long-term viability of the vital NAS system." To achieve this goal, the Department must collect and analyze reliable financial data on the NAS airports.

Good practices

- The Vancouver Airport Authority, which owns subsidiaries in areas such as airport management, disclosed financial data and information on its subsidiaries in its *2003 Annual Report*.
- The Halifax, Ottawa, Moncton, Victoria, Edmonton, and Toronto airport authorities explained in their 2003 annual reports what the airport improvement fees they collected were used for. The revenue collected from airport improvement fees is meant to fund airport infrastructure construction.
- In their 2003 annual reports, the Edmonton and Ottawa airport authorities disclosed the credit ratings they received from the credit bureaus who analyzed their financial status.

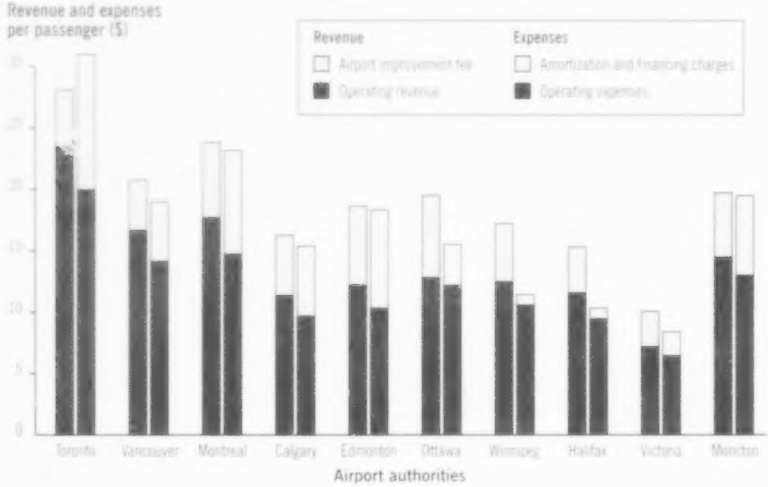
2.51 The Department is now monitoring annually the financial situation of the airport authorities. It receives the authorities' audited financial statements, as stated in the lease, and analyzes them. Exhibit 2.6 shows the revenue and expenses per passenger for 10 airport authorities for 2003. The appendix is a summary of the financial results of these airport authorities.

2.52 The Department also collects information on the authorities' subsidiaries. When necessary, it conducts spot checks of any airport authority whose financial situation raises concerns.

2.53 Over the last two years, the Department has overseen the long-term financial viability of the airport authorities, with data collected from the Airports Rent Policy Review. The review allowed the Department to establish financial projections for the next 20 years for the airport authorities. While the Department has paid close attention to the quality of the data used, it has not determined how it will continue to monitor the long-term financial viability of the authorities once the data becomes obsolete.

2.54 Also, Transport Canada has not developed a comprehensive strategy for responding in the event that an airport authority encounters serious financial difficulty. Although the Department would have no liability if this happened, a strategy would help it respond quickly if necessary. The Department recently developed a discussion paper on the subject.

Exhibit 2.6 Revenue and expenses per passenger for 10 airport authorities in 2003



Source: Transport Canada

2.55 **Recommendation.** Transport Canada should clarify how it will continue overseeing the long-term viability of the NAS once the data from the Airports Rent Policy Review becomes obsolete. In particular, it should determine what data to collect; who will collect it, how often, and how it will be collected; and how the results will be used.

Transport Canada's response. To determine if policies and frameworks are working as intended and to provide "early warning" indicators of potential financial trouble at an airport, the Department intends to build upon the work it did assessing the long-term viability of the leased NAS airports for the Rent Policy Review. To facilitate this, the existing forecast model would be updated, on an ongoing basis, with current financial and traffic data.

2.56 **Recommendation.** Transport Canada should develop a comprehensive strategy for responding in the event that an airport authority encounters serious financial difficulty. In particular, the strategy should state who in the Department would assume primary responsibility, when the Department would intervene and the methods it would use, and the legal limits of the intervention.

Transport Canada's response. Transport Canada concurs. As noted in the Department's discussion paper, serious financial difficulty can arise from a variety of underlying causes, which may accordingly require different skill sets (finance and accounting, policy, operations, etc.). The Department will develop a variety of case scenarios to ensure it can

(i) assign primary responsibility in any foreseeable case;

(ii) marshal the necessary information for decision makers to decide whether to intervene, and if so, how; and

(iii) identify the legal and financial authorities the Department has or would have to obtain for such a case.

Transport Canada conducted a study of the financial situation of the regional airports

2.57 Transport Canada conducted the Regional and Small Airports Study, following a request by Cabinet to find out how the sale of these airports to local interests had affected their financial situation.

2.58 Since Transport Canada sold the regional airports, it no longer has to guarantee their viability. However, the Department needs a minimum of information on the financial situation of the major regional airports, so it can factor in the potential impacts of the airports' financial situation on the vitality of the air transportation system, and report to decision makers and Parliament.

2.59 The study, recently completed, has provided up-to-date information on the financial situation of the major regional airports. However, the Department has not considered how it could continue to monitor their financial situation.

2.60 We encourage Transport Canada to determine how it will monitor the financial situation of the major regional airports. Among other things, the Department needs to identify the airports to monitor; determine what data to collect, who will collect it, how it will be collected, and how often; and how the results will be used.

Measuring the performance of the airports

TRANSPORTATION
IN CANADA 2003
ANNUAL REPORT

Canadä

Transportation in Canada, a report tabled annually in Parliament, is used by Transport Canada to present information on the state of transportation in Canada.

Transport Canada does not measure the performance of the airports

2.61 In 2000, we observed that Transport Canada had not determined how to measure the performance of the airports; we recommended that it design a framework to do this.

2.62 Over the past few years, and particularly in its *2000–01 Report on Plans and Priorities*, Transport Canada has made efforts to determine what kind of performance information about the Canadian airports would be useful for departmental decision makers, members of Parliament, airport authorities, and stakeholders. In its draft legislation on airports, the Department included sections on measuring performance, notably the requirement for airport authorities to establish performance indicators.

2.63 However, the Department has not identified the areas of airport performance it needs to measure or how it will use the information. Also, it has not approved a framework to show how it expects to do it. The Department needs to finalize the framework, as soon as possible, so it can let the airport authorities know the areas of performance it wants to measure and the indicators it plans to use, especially if it relies on information from the authorities.

2.64 The only data on airport performance that Transport Canada provides, in its report *Transportation in Canada*, is on finances and passenger volume. For example, *Transportation in Canada* and the Department's performance report do not contain information on the level of service offered to the public by the airports.

2.65 **Recommendation.** Transport Canada should

- develop a framework identifying the airports whose performance it wants to measure; what it needs to measure; what data it needs to collect, who will collect it, how it will be collected, and how often; how it will use the results; and how it will report on the performance;
- have the framework approved by departmental executives; and
- start, as soon as possible, collecting data, measuring the airports' performance, and reporting on the results.

Transport Canada's response. Transport Canada recognizes the importance of developing and implementing a performance-monitoring framework. This was reflected in early drafts of a proposed legislative framework for airports (2003). To ensure that airport business dynamics and data availability are taken into consideration, this project would be developed in consultation with the relevant airports to identify and prioritize appropriate performance measures. The Department will enhance its data gathering capabilities, as well as determine the best approach to report the results.

Collecting air transportation statistics electronically to reduce time and cost

Statistics on passenger volume are essential for measuring the current performance of the airports and establishing financial projections for the airport authorities. Transport Canada launched its Electronic Collection of Air Transportation Statistics initiative to help air carriers collect data more easily and send them to the Department electronically, to substantially shorten the time it takes to collect the data, and to reduce the cost to industry and the government. The Department expects that, by the end of March 2005, the majority of air carriers serving Canadian airports, including foreign carriers, will participate in this initiative.

Transport Canada has reported to Parliament on the transfer of the airports

2.66 In 2000, we recommended that Transport Canada report to Parliament, on a timely basis, on the impact of the transfer of the NAS airports. Transport Canada has since provided information to Parliament on the transfer in its reports on plans and priorities, performance reports, and *Transportation in Canada*. Specifically, the Department has reported on its five-year review of the transfer of the first five airports and on the key measures it developed as a result of the review—the proposed legislation on airports, the National Airports Rent Policy Review, and the lease monitoring program.

Where can I find information on the airport authorities?

In our audit, we examined Transport Canada's records on 13 airport authorities. These airport authorities have Web sites that inform visitors about their organization and offer various documents including annual reports. The Victoria Airport Authority, for example, has a Web site where Canadians can easily find information on governance.

2.67 The Department has also reported to Parliament on the short-term assistance it provided airport authorities in 2003. We expect that once the results of the Airports Rent Policy Review are known, the Department will provide a timely report to Parliament that highlights the financial impact for the government, airport authorities, and users.

2.68 However, in recent years, the public has not found it easy to obtain information on the airport transfers. In 1999, Transport Canada summarized the preliminary findings of its five-year review for its consultations with stakeholders. The Department did not post the summary on its Web site, which would have made it easier for members of Parliament, stakeholders, and Canadians to consult it. Similarly, none of the studies on the Airports Rent Policy Review had been posted on Transport Canada's Web site, as of November 2004, even though the Department does intend to post studies that do not contain confidential information.

2.69 The Department has recently added a number of documents of interest to its Web site: the consultation paper on the five-year review, the terms of reference for the National Airports Rent Policy Review, and the Regional and Small Airports Study.

2.70 We encourage Transport Canada to make it easier for members of Parliament, stakeholders, and Canadians to obtain information on the transfer of the airports and on their performance, notably by posting documents on its Web site.

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Accountability

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Conclusion

2.71 Transport Canada has made satisfactory progress in implementing the recommendations of our 2000 audit.

2.72 We found that Transport Canada has done the following:

- Almost concluded the National Airports Rent Policy Review, which will allow it to assess the financial impact of the transfer of the airports in the National Airports System. The review will determine, among other things, the impact that rent charges have on the viability of the airport authorities and air carriers and on the government's finances. It will also determine whether the current rent policy is fair to taxpayers, users, and airport authorities.
- Clarified and assumed its role as owner, landlord, and overseer of the airports, and established good relations with the airport authorities.
- Established a lease monitoring program. The Department found a high level of compliance by airport authorities with the provisions of their lease. The authorities are maintaining the airport facilities in as good or better condition than before the transfer. Also, they are exercising due diligence regarding environmental protection and complying with the lease provisions on public interest and governance.
- Started to monitor the financial situation of the airport authorities annually and oversee the long-term viability of the NAS.
- Reported to Parliament on the transfer of the NAS airports.

2.73 However, Transport Canada has not kept to the schedule it set for the National Airports Rent Policy Review. The review began in 2001 and was to be completed in fall 2002; it is still in progress. Department officials are aware that the delay could have potentially significant financial impacts on some of the airport authorities.

2.74 Also, Transport Canada does not measure the airports' performance, with the exception of financial data. The Department has not yet identified the areas it needs to measure and has no approved framework showing how it would measure performance.

About the Follow-Up

Objective

The objective of the follow-up was to evaluate the extent to which Transport Canada implemented the recommendations of our October 2000 Report, Chapter 10, on the transfer of the airports in the National Airports System. These recommendations are listed in paragraph 2.14.

Scope and approach

We examined the measures that Transport Canada had adopted to:

- assess the financial impact of the transfer of the NAS airports;
- oversee the financial viability of the NAS;
- measure the airports' performance;
- report the findings to Parliament; and
- monitor the airport authorities' leases (we examined Transport Canada's files on 10 airport authorities: Victoria, Vancouver, Edmonton, Calgary, Winnipeg, Toronto, Ottawa, Montréal, Moncton, and Halifax).

We did not examine issues of airport safety and security.

We met with Transport Canada staff in Ottawa, Vancouver, Edmonton, Winnipeg, Toronto, Montréal, and Moncton. We also discussed the National Airports Rent Policy Review with officials from the Department of Finance. Last, we met with officials from a number of airport authorities and air transportation organizations.

Criteria

We expected that Transport Canada

- had clearly defined its roles and responsibilities for the National Airports System;
- had observed sound management practices in managing and administering agreements with the airport authorities and for the National Airports System as a whole;
- had kept abreast of new developments to safeguard public assets and protect taxpayers' interests; and
- was monitoring and analyzing the results and impact of the airport transfers, the workability of the National Airports System, and the maintenance of leased facilities, and reporting these matters to decision makers and Parliament.

Audit team

Assistant Auditor General: Richard Flageole
Principal: Sylvain Ricard
Lead director: Gisèle Grandbois
Directors: Mario Malouin, Peter Morrison

Doreen Deveen
Véronique Duguay
Isabelle Marsolais
John McGrath
Francis Séguin
Marc Vachon

For information, please contact Communications at (613) 995-3708 or 1-888-761-5953 (toll free).

Appendix Financial results of 10 airport authorities in 2003 ($ thousands)

	Toronto	Vancouver	Montréal	Calgary	Edmonton	Ottawa	Winnipeg	Halifax	Victoria	Moncton
Consolidated statement of operations (for the year ended 31 December 2003)										
Aeronautical revenues	360,434	99,469	67,395	47,805	25,567	21,921	18,591	17,492	3,433	3,363
Non-aeronautical revenues	180,572	120,610	87,466	39,160	18,732	17,912	14,820	14,054	5,172	2,925
Operational revenues	541,006	220,079	154,861	86,965	44,299	39,833	33,411	31,546	8,605	6,288
Airport improvement fees	105,857	54,437	53,525	37,341	23,326	20,838	12,672	10,199	3,465	2,288
Total revenues	646,863	274,516	208,386	124,306	67,625	60,671	46,083	41,745	12,070	8,576
Rent to federal government	125,211	66,300	4,805	23,408	2,358	11,329	3,755	3,191	1,096	
Salaries and wages	85,504	30,486	38,889	10,477	12,893	10,066	11,780	10,399	2,419	1,910
Other operating expenses	249,353	90,091	85,179	40,188	22,222	16,465	12,797	12,218	4,214	3,741
Operational expenses	460,068	186,876	128,873	74,073	37,473	37,860	28,332	25,808	7,729	5,651
Interest and financing charges	157,086	22,184	26,612	13,751	14,655	4,682			873	1,684
Amortization	96,479	41,957	47,138	29,712	14,354	5,724	2,284	2,307	1,465	1,141
Total expenses	713,633	251,017	202,623	117,536	66,482	48,266	30,616	28,115	10,067	8,476
Settlement of a lawsuit relating to Château Mirabel	N/A	N/A	20,670	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Net income (net loss)	(66,770)	23,499	(14,907)	6,770	1,143	12,405	15,467	13,630	2,003	100
Consolidated balance sheet (as at 31 December 2003)										
Total assets	5,872,430	936,203	1,122,643	634,609	324,428	381,547	78,749	62,125	31,128	31,850
Long-term debt	5,571,623	305,664	800,000	370,000	248,957	274,198		6,026	13,214	26,065
Total liabilities	5,871,256	358,845	945,640	415,584	264,636	302,811	8,957	13,844	15,054	27,657
Total net assets	1,174	577,358	177,003	219,025	59,792	78,736	69,792	48,281	16,074	4,193

Source: Transport Canada and airport authorities' 2003 annual reports

Chapter

3

Modernization of Human Resources Management

Managing the Reforms

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Modernization of Human Resources Management

Managing the Reforms

Main Points

3.1 The government is making satisfactory progress in the early stages of its implementation of a new legislative framework for human resources management in the federal public service. The new framework will not be fully implemented until December 2005 at the earliest, and the full impact of the changes will not be evident until several years later. This is the most significant legislative change to the framework since the mid-1960s. The government has established a good foundation for the management of its human resource reforms, and we found leadership and a sense of purpose.

3.2 For the most part, roles and responsibilities for human resources management have been clarified. However, the Treasury Board needs to ensure that the three agencies that now carry out the various aspects of its role as employer (the Treasury Board Secretariat, the Public Service Human Resources Agency, and the Canada School of Public Service) integrate their activities more formally and fully. In particular, the role of the new Public Service Human Resources Management Agency of Canada needs to be further clarified to define its expected contribution to human resources governance and its relationship to the other stakeholders.

3.3 Some of the major organizational changes required by the legislation (the transfer of certain functions from the Public Service Commission and the creation of the Canada School of Public Service) occurred relatively smoothly. A strong project management process has been put in place to manage the many changes needed, and it has received strong leadership from the deputy minister community.

3.4 As the full impact of changes envisioned by the legislation will take some years, the government will need to maintain the focus and momentum of this significant reform initiative. This will be a challenge given the many demands on the public service today. The government needs to clearly define the outcomes it expects from this reform, and it needs to monitor and report on ongoing progress. It also needs to ensure that it monitors, controls, and reports on the full costs of this reform.

Background and other observations

3.5 Parliament passed the new *Public Service Modernization Act* in November 2003. The Act made significant amendments to four related pieces of legislation affecting human resources management in the public service: the *Public Service Employment Act*, the *Financial Administration Act*, a new *Public Service Labour Relations Act* (replacing the *Public Service Staff Relations Act*), and the new *Canada School of Public Service Act* (replacing the *Canadian Centre for Management Development Act*).

The departments have responded. The Treasury Board of Canada Secretariat, the Public Service Human Resources Management Agency of Canada, and the Public Service Commission have generally agreed with our recommendations.

Introduction

A call for a new human resources management regime

3.6 The federal public service delivers programs and services to Canadians and provides advice to ministers and officials on a wide range of matters. The salaries and related costs of maintaining a public service are a major government expenditure. Given the major changes occurring in the public service in terms of a shift in the nature of work, its demographics, and an increasingly tight market for talent, the government must be able to manage its human resources effectively. The public service needs to be organized and well managed in order to maintain its tradition of excellence.

3.7 In our April 2000 Report, Chapter 9, Streamlining the Human Resources Management Regime: A Study of Changing Roles and Responsibilities, we noted long-standing concerns about the fragmentation of roles and responsibilities for human resources management in the federal public service. We also noted, as we had in a number of previous reports, that the current human resources management regime was cumbersome, complex, inflexible, and outdated.

3.8 The Public Accounts Committee held hearings on this matter in 2000 and 2001 and recommended a legislative review to streamline the staffing function, clarify the roles and responsibilities of the various stakeholders, and generally modernize human resources management.

3.9 In April 2001, the government indicated its intent to reform the public service and, to that end, initiated a two-pronged approach to modernizing human resources management, including legislative and non-legislative changes. The Prime Minister announced the formation of the Task Force on Modernizing Human Resources Management in the Public Service. Its mandate was to recommend a modern institutional framework for managing human resources. The Clerk of the Privy Council listed three guiding principles as the foundation for reforms: protecting the merit principle, delegating human resource management matters to the lowest possible managerial level, and ensuring that managers were accountable for results. The work of the Task Force resulted in the tabling of the *Public Service Modernization Act* in February 2003. It received royal assent on 7 November 2003.

A summary of legislative changes

3.10 The new *Public Service Modernization Act* (PSMA) made significant changes to the existing legislative framework. Part 1 of the Act replaces the *Public Service Staff Relations Act* with the *Public Service Labour Relations Act* (PSLRA). The changes reflect many of the recommendations of the 2001 report on labour management relations, *Working together in the Public Interest* (the Fryer Report). For example, the new PSLRA calls for labour relations based on greater co-operation and consultation between the employer and bargaining agents. It establishes the Public Service Labour Relations Board as a mechanism for resolving disputes. The new Board replaces the old Public

Service Staff Relations Board but has a broader mandate, including a compensation research function and increased mediation services.

3.11 Part 2 of the PSMA amends the *Financial Administration Act*. It makes deputy ministers directly responsible for certain aspects of human resources management, while the Treasury Board of Canada remains the employer. Other amendments further improve reporting to Parliament by the Treasury Board on human resource management issues.

3.12 Part 3 of the PSMA makes significant amendments to the existing *Public Service Employment Act* (PSEA). The intent of these amendments is to modernize staffing by defining merit and providing more flexibility and creating new rules to govern the political activities of public servants. The revised PSEA creates new arrangements for handling internal staffing complaints. The Act encourages the discussion and resolution of employee concerns at the departmental level, as soon as possible. The PSEA creates the Public Service Staffing Tribunal, which will consider and resolve complaints related to lay-offs, revocation, and allegations of abuse of authority. The Tribunal is a new, formal stakeholder in human resources management.

3.13 Part 4 of the PSMA creates the Canada School of Public Service, which intends to integrate and better co-ordinate common training and development activities of the federal public service.

3.14 The nature of many provisions of the various acts is enabling rather than prescriptive. That is, they provide options rather than rules to allow more discretion in managing human resources to meet specific business needs of government departments.

3.15 The Appendix provides a more detailed explanation of the major changes in the legislation.

3.16 Although the *Public Service Modernization Act* was adopted in November 2003, its various legislative components come into force at different times. For example, the Canada School of Public Service was created in April 2004; amendments to the *Public Service Labour Relations Act* and the *Financial Administration Act* take effect in April 2005. These amendments set out the respective responsibilities of the Treasury Board and deputy heads in human resources management. The *Public Service Employment Act* is scheduled to be fully implemented in December 2005.

3.17 An important feature of the new legislative framework is the use of preambles in the PSLRA and the new PSEA. These preambles set out the core values and principles for the management of human resources. The Fryer Report recommended a preamble to outline a set of principles to guide the relationships among the parties, thus limiting the need for prescriptive lists of conditions. Both acts also require a review five years after coming into force.

3.18 The legislative changes are the most extensive since the mid-1960s. In testimony before a parliamentary committee studying the legislation, we said that we considered the legislative proposals to be improvements over the existing systems and that they would contribute to reforming human resources management.

Other changes were identified to support a new regime

3.19 Over several years, the government identified areas of human resources management that needed improvement but did not require legislative change. It committed to continue working in these areas, which include classification reform, integration of human resources planning with business planning, values and ethics, national areas of selection, and the term employment policy. Exhibit 3.1 provides details of some of these projects.

3.20 The government expected that collectively, the legislative changes and other reforms would simplify human resources management and allow more flexibility. It also expected, as a result, better labour relations and human resources management systems and practices based on values such as merit and non-partisanship.

Organizational changes were announced after the passage of legislation

3.21 On 12 December 2003, the government announced changes that directly affected human resources management. In particular, it created the Public Service Human Resources Management Agency of Canada, reporting to the President of the Privy Council. This was changed by an order-in-council on 20 July 2004; the Agency now reports to the President of the Treasury Board.

Focus of the follow-up

3.22 Our follow-up audit examined the management of the implementation of the new human resources legislation, and assessed the government's progress on its other human resources modernization initiatives. We expected that the new legislation would clarify the roles and responsibilities of central agencies and deputy ministers in human resources management. We also expected that the legislative changes and other modernization initiatives would be supported and managed effectively. We looked for clear plans outlining accountabilities for implementing those other initiatives.

3.23 We recognize that it will take some time to fully implement the new legislative and administrative frameworks. This follow-up sought to assess the government's progress toward establishing a solid foundation for reforming human resources management at an early stage in implementation. Our Office committed to reporting back to Parliament on that progress and we will continue to monitor it. Our follow-up scope and criteria are set out in **About the Follow-Up** at the end of the chapter.

Exhibit 3.1 A sample of non-legislative initiatives underway or completed

Non-legislative initiative	Description and status
Classification reform: Modernizing the standards (Public Service Human Resources Management Agency of Canada [PSHRMAC])	• To modernize, on an ongoing basis, classification standards as a basis for effective staffing and compensation across the public service. • The foreign service officer standard design is complete and is at the collective bargaining stage; draft standards of the economics, statistics and sociology, and border services groups are complete. • PSHRMAC has yet to release its annual update to Parliament on the progress of classification reform.
Compensation policy framework (Treasury Board Secretariat [TBS])	• Framework for determining and implementing negotiated settlements to improve the government's ability to attract and retain employees to the public service. Considers internal and external comparability, individual/group performance, and affordability. • A draft of the policy is complete.
Core learning for employees, managers, and functional specialists (PSHRMAC/Canada School of Public Service)	• Five year project that identifies the core learning needs of employees, management, and functional specialists to work efficiently and to effectively manage the business operations in the public service toward the achievement of results for Canadians. • Library of core knowledge of middle managers is complete; currently piloting core knowledge requirements of middle managers in financial management.
Values and Ethics Code for the Public Service (TBS)	• Code that sets forth the values and ethics of the public service to guide and support public servants in their professional activities. • The Code came into force on 1 September 2003.
Term Employment Policy (TBS/Public Service Commission [PSC])	• Policy to balance the fair treatment of term employees with the need for operational flexibility. Replaces the Long-term Specified Period Employment Policy and reduces the cumulative working period of term employees to qualify for indeterminate employment from 5 years to 3 years. • The policy came into force between 1 April 2003 and 1 April 2004.
National areas of selection (PSC)	• A plan to expand the use of national areas of selection for jobs open to the general public, thereby removing geographical limits and enhancing Canadians' access to jobs in the federal public service. • National areas of selection for open competitions of senior officer-level jobs were implemented in the fall of 2001. In 2002, a pilot project was conducted for middle and junior officer-level jobs.
e-Recruitment (PSC)	• A plan to adopt modern recruitment technology to expand the use of national areas of selection for jobs in the public service. Modern recruitment technology is required to process a much higher volume of applications received under an expanded area of selection. • Piloted an existing electronic recruitment system in 2002 and launched an interim in-house technology solution (public service resourcing system) in April 2003. • Require long-term funding ($40 million) to implement the plan.
Pre-qualified pools (PSC)	• Delegated the authority to establish pre-qualified pools to four departments on a pilot basis to test possible options that new legislation will open up.

Source: Public Service Human Resources Management Agency of Canada, Public Service Commission, and Treasury Board Secretariat

Observations and Recommendations

Positive legislative changes

3.24 In our April 2000 Report, Chapter 9, Streamlining the Human Resources Management Regime: A Study of Changing Roles and Responsibilities, we found that the roles and responsibilities for managing the government's human resources were fragmented. In particular, we noted that the respective roles of central agencies and deputy heads in this vital area needed to be clarified. The new *Public Service Modernization Act* (PSMA) contributes significantly to that clarification.

3.25 The PSMA essentially consolidated and re-assigned a number of human resource management functions (Exhibit 3.2).

Treasury Board's role as employer was consolidated

3.26 The new PSMA clarifies and reinforces the Treasury Board of Canada's role, as employer, in developing policies and monitoring and overseeing all key aspects of human resources management except for staffing. As the government's general manager, the Treasury Board Secretariat of Canada was expected to guide the implementation of the changes.

3.27 The Treasury Board retained many of its powers, particularly in the areas of labour relations and collective bargaining, pensions and benefits, employment policies, human resource requirements, classification of positions and rates of pay. It also retained its powers to establish qualifications for professional development programs and to make regulations on deployments and appointments to level. The Board will have full responsibility for planning for the human resource needs of the public service (a function that had been split between the Public Service Commission and the Board).

Appointment to level—An appointment based on an employee's ability to function at a certain level rather than the level of the position the employee occupies.

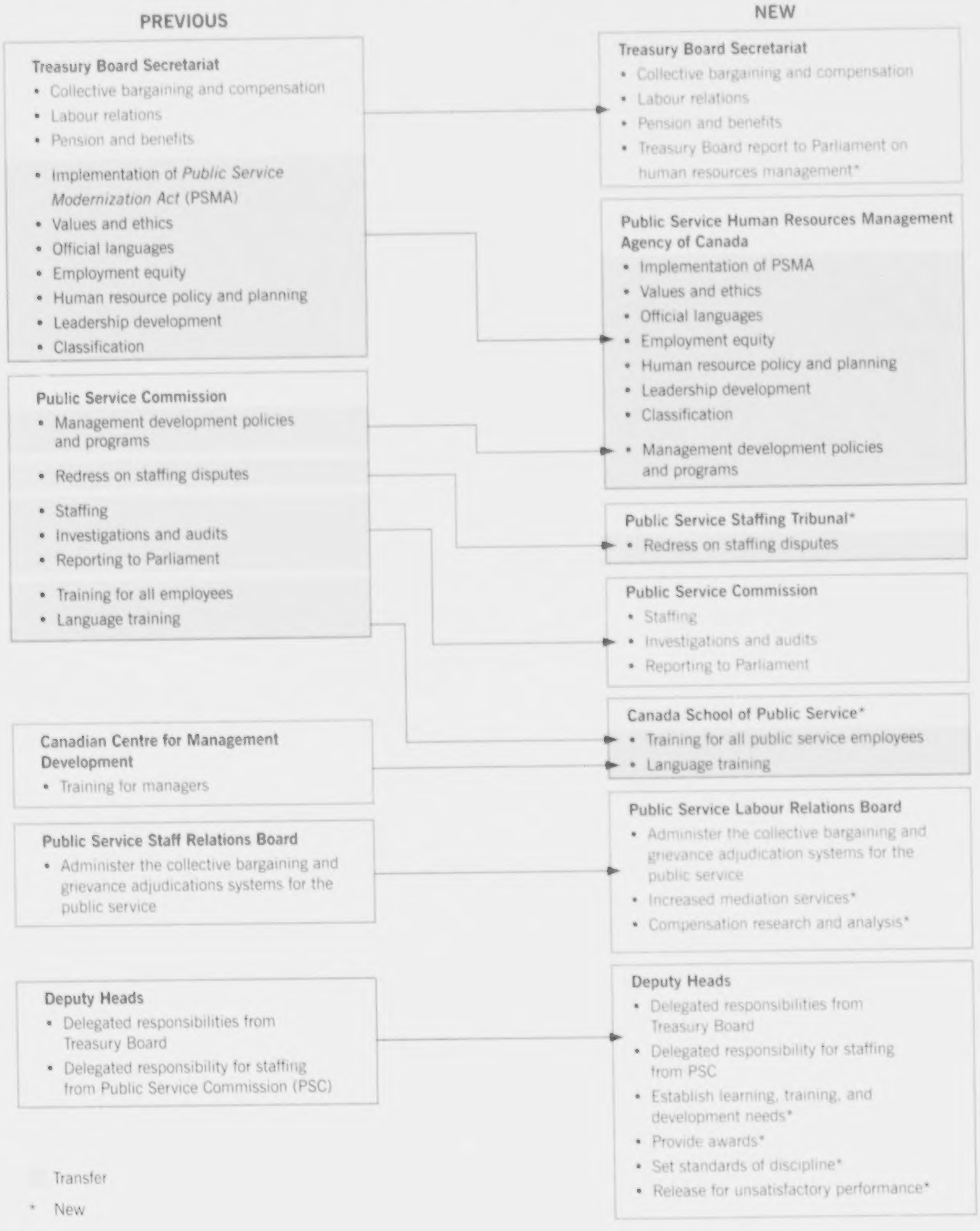
3.28 The revisions to the *Public Service Employment Act* (PSEA) also transfer certain powers to the Board from the Commission. For example, the Treasury Board will be responsible for setting the qualification standards used in the staffing of positions, setting probationary and notice periods, and determining rates of pay on appointment. Finally, as a new requirement, the Board must report on human resource matters that fall under its authority, which increases its oversight role in matters of human resource management.

3.29 Consistent with principles of increased delegation, deputy heads now have some direct powers over human resources management. However, to ensure consistency and accountability across the public service, the Board is still responsible for establishing policies and issuing guidelines on deputy heads' use of their powers and their reporting obligations.

3.30 The intent is an integrated approach to human resources management that clearly defines responsibility and accountability for key functions—an approach that we reported was lacking in 2000.

3.31 We note that although the Treasury Board remains responsible for human resources management under law, some of its functions managed by the Treasury Board Secretariat were moved by the government to the Public Service Human Resources Management Agency of Canada in December 2003. We discuss some concerns with this in paragraphs 3.65 to 3.73.

Exhibit 3.2 Human resources management structure—Transfer and creating responsibilities


PREVIOUS
NEW
Treasury Board Secretariat
• Collective bargaining and compensation
• Labour relations
• Pension and benefits
• Implementation of *Public Service Modernization Act* (PSMA)
• Values and ethics
• Official languages
• Employment equity
• Human resource policy and planning
• Leadership development
• Classification
Public Service Commission
• Management development policies and programs
• Redress on staffing disputes
• Staffing
• Investigations and audits
• Reporting to Parliament
• Training for all employees
• Language training
Canadian Centre for Management Development
• Training for managers
Public Service Staff Relations Board
• Administer the collective bargaining and grievance adjudications systems for the public service
Deputy Heads
• Delegated responsibilities from Treasury Board
• Delegated responsibility for staffing from Public Service Commission (PSC)
Treasury Board Secretariat
• Collective bargaining and compensation
• Labour relations
• Pension and benefits
• Treasury Board report to Parliament on human resources management*
Public Service Human Resources Management Agency of Canada
• Implementation of PSMA
• Values and ethics
• Official languages
• Employment equity
• Human resource policy and planning
• Leadership development
• Classification
• Management development policies and programs
Public Service Staffing Tribunal*
• Redress on staffing disputes
Public Service Commission
• Staffing
• Investigations and audits
• Reporting to Parliament
Canada School of Public Service*
• Training for all public service employees
• Language training
Public Service Labour Relations Board
• Administer the collective bargaining and grievance adjudication systems for the public service
• Increased mediation services*
• Compensation research and analysis*
Deputy Heads
• Delegated responsibilities from Treasury Board
• Delegated responsibility for staffing from PSC
• Establish learning, training, and development needs*
• Provide awards*
• Set standards of discipline*
• Release for unsatisfactory performance*
▨ Transfer
* New

The new legislation means the Public Service Commission can focus on its key roles

3.32 In the past, our Office has commented on the many roles played by the Public Service Commission that created a potential for conflict. In earlier studies, the Commission pointed to the potential conflict in finding itself "increasingly present at tables comprising the very officials whose staffing decisions it may be adjudicating, reviewing or auditing."

3.33 Several of the Commission's non-core, operational functions have been transferred to other organizations (Exhibit 3.2). What the Commission retains is sole responsibility for staffing, carrying out investigations and audits, and reporting to Parliament. The new *Public Service Employment Act* (PSEA) proposes that all staffing responsibilities be delegated to deputy heads, except those relating to the political activities of public servants. The Commission is working on a revised delegation and accountability framework that will clearly spell out the responsibilities and accountabilities of deputy heads under the new regime.

3.34 In its key role of protecting the merit principle, the Commission is increasing its oversight activities and rebuilding its audit function through the reallocation of its existing resources. It will need to manage the appeals process for some time after the new PSEA comes into force, because staffing actions begun before that point are to be dealt with under the current system.

3.35 Although many of the Public Service Commission's former operational roles have been shifted to others, it retains some of those responsibilities. For example, it is still responsible for general advertising of positions in the government. The Commission expects to provide some operational assistance to small agencies that lack the resources of larger departments. It will also have to address how to provide services to departments whose delegated authority for staffing has been withdrawn. To address the challenges posed by its ongoing dual role for operations and oversight, it is placing its operational responsibilities in one area as a service agency, headed by a vice-president reporting directly to the president. This arrangement is designed to separate the Commission's service and oversight roles. However, the challenges posed by its dual roles will have to be carefully managed.

The learning function is consolidated

3.36 The *Public Service Modernization Act* created the Canada School of Public Service to provide a single focal point for all training and professional development in the public service. It replaces the Canadian Centre for Management Development and takes over the Public Service Commission's previous roles in training. It also brings a more unified approach to meeting the common learning and development needs of public servants, such as training in financial and human resources and information management, procurement and other professional development areas, orientation to the public service, ethics and values, supervision/leadership/management practices, and language training. As of 20 July 2004, the president of the School reports to the president of the Treasury Board. Given that the Board is responsible for policies on learning, this adds more coherence to training and professional development.

Deputy heads will have more direct responsibility for human resources management

3.37 For the first time, deputy heads' responsibility for human resources management is defined in the revisions to the *Financial Administration Act* (FAA), the PSEA, and the PSLRA. We note that many of the provisions enable rather than prescribe; this will allow departments to move forward with new initiatives as they develop their capacity to take advantage of flexibilities. Many of the provisions allow for a more direct and immediate response to workplace issues, stronger relationships with unions and employees, and earlier resolution or reduction of conflict. Specifically, deputy heads must establish effective union-management committees to deal with immediate concerns, and to set up processes for early dispute resolution. More information on the new roles for deputy heads can be found at www.publiservice.hrma-agrh.gc.ca.

Implementing the reforms

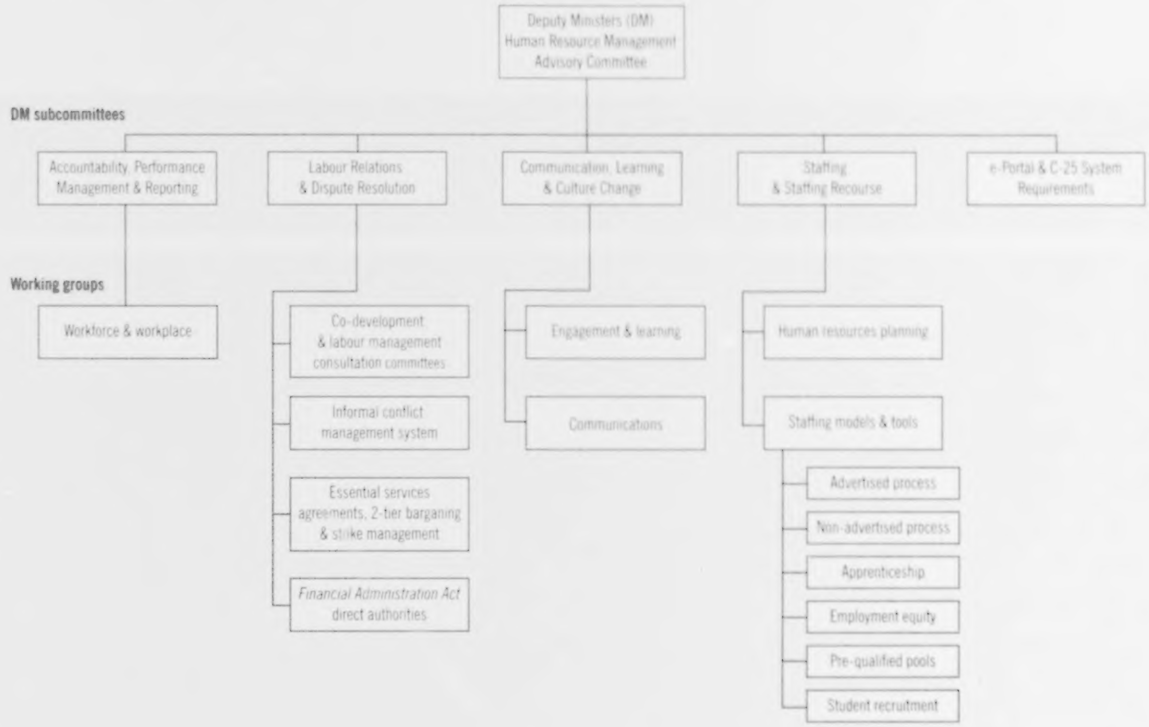
3.38 Along with its recommendations for modernizing human resources management, the Public Accounts Committee said the government had to ensure the clear definition of the roles and accountability for implementing the legislative reforms. To that end, the government set up a committee structure for co-ordinating the many aspects of implementing the PSMA. It also implemented a strong project management structure consistent with the accountability principles that our Office outlined in our 2002 Report, Chapter 9, Modernizing Accountability in the Public Service; it is also consistent with the Treasury Board's policy on project management.

The new management and co-ordination structure is guiding implementation

3.39 In 2003, the Treasury Board Secretariat established the Deputy Ministers Human Resource Management Advisory Committee (known as the MAC). The membership of the Committee and its subcommittees, chaired or co-chaired by deputy heads (Exhibit 3.3), reflects the importance the government has attached to implementing the PSMA and reforming the management of its human resources. The amount of time deputies are investing to support the modernization of human resources management among their many competing demands and priorities reflects their commitment to support the new regime. The MAC has become a permanent subcommittee of COSO, the Committee of senior officials (senior deputy ministers) that provides advice to the Clerk of the Privy Council on the management of the public service.

3.40 The MAC was initially established to oversee the implementation of the PSMA. However, in the spring of 2004, its role was expanded to reviewing all changes in human resources management as many of the non-legislative concerns have an impact on the legislative changes. An example of this interdependency is the linking of human resources planning with business planning. Because the new legislation allows departments to consider future requirements when they hire for existing positions, they need good planning and a sound understanding of human resources they will require in the future. The case study, Human Resource Planning, describes the work being done to improve human resources planning.

Exhibit 3.3 Deputy Ministers Human Resource Management Advisory Committee


Deputy Ministers (DM) Human Resource Management Advisory Committee
DM subcommittees
Accountability, Performance Management & Reporting
Labour Relations & Dispute Resolution
Communication, Learning & Culture Change
Staffing & Staffing Recourse
e-Portal & C-25 System Requirements
Working groups
Workforce & workplace
Co-development & labour management consultation committees
Informal conflict management system
Essential services agreements, 2-tier barganing & strike management
Financial Administration Act direct authorities
Engagement & learning
Communications
Human resources planning
Staffing models & tools
Advertised process
Non-advertised process
Apprenticeship
Employment equity
Pre-qualified pools
Student recruitment

Source: Public Service Human Resources Management Agency of Canada

3.41 A committee of assistant deputy ministers mirrors the MAC. Its job is to ensure the horizontal integration of project plans and priorities, identify corporate resources allocated to projects, and monitor challenges and priorities. It acts as the main "traffic controller" for the information flow among committees and the items going forward to the MAC.

3.42 Each subcommittee has a network of working groups that enables line managers, representatives from the regions, and bargaining agents to provide input. The subcommittees provide strategic advice on carrying out the PSMA, while the working groups provide options for implementing policy guidance and the detailed content for practical tools, guidance, and direction needed to support the use of the PSMA in departments. Final approval of any policy remains with the organization responsible for the policy. For example, all policies and issues on staffing require the approval of the Public Service Commission while the policies and issues on labour relations are under the authority of the Treasury Board Secretariat. These measures are significant because they reinforce the accountability of those who are responsible for the policies.

Human resources planning

Human resources planning is now seen as a critical enabler to achieve the full flexibility of the new *Public Service Employment Act*.

The Treasury Board (as employer) is responsible under the *Financial Administration Act* for identifying the current and future needs of the public service, and for establishing basic qualification standards for positions. The new *Public Service Employment Act* enables deputy heads to fill positions based on essential qualifications and considerations for current and future needs at the organizational level. In light of this, the capacity for building a more systematic approach to human resources planning has become a priority.

An interdepartmental human resources planning working group was created in October 2003. Its mandate was twofold: develop a generic planning template that departments and agencies could adapt to their needs and prepare a discussion paper outlining the current state of human resources planning in the public service, improvements needed, and the steps required to rebuild capacity across the public service. The working group has made significant progress on both fronts.

Based on extensive consultation and research, the working group drafted a number of planning tools, including a planning calendar and checklist, tool kit, and guide. These tools are intended to support integrated human resources planning and business planning practices in departments and agencies. In April 2004, the working group also published a discussion paper with several recommendations to help improve the state of planning practices and capacity across the public service. The working group expects to formally roll out the planning tools to departments and agencies in December 2004, and to work on re-building planning capacity and an improved process over the next three to five years.

In addition to the working group, the Public Service Human Resources Management Agency of Canada recently established a planning team and a Centre of Excellence to help support departments and agencies in re-building their human resources planning capacity.

3.43 As they stated in parliamentary hearings on the legislation and subsequently, the unions have significant concerns about what they view as shortcomings in the legislation. Despite this, some unions have seconded some of their staff to work with the government's project management team, and others have participated in working groups and subcommittees. Officials from the Public Service Human Resources Management Agency of Canada and the Public Service Commission have commented on the positive working relationship and useful input that the unions have brought to the process.

3.44 The heads of the Treasury Board Secretariat, the Public Service Human Resources Management Agency of Canada, the Public Service Commission, and the Canada School for Public Service meet informally but regularly to discuss the implementation of the PSMA, other change initiatives, and requirements for additional support. Their collaboration at the top has sent a message to their respective staffs to work together toward the common goal of modernizing human resources management.

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3.45 The structure of the MAC with its subcommittees and working groups, the reasonably broad participation of stakeholders, and the meetings of central agency deputy heads has permitted a collaborative approach to managing implementation activities. Clearly the "tone at the top" is appropriate, with support at the highest levels of management and in the central agencies.

Consistent project management practices have been implemented

3.46 Implementing a new regime for human resources management requires the government to follow sound project management practices. These practices are critical to ensuring the integration of many projects and activities directed toward reform, whether the changes are legislative or non-legislative.

3.47 We found that the basic elements of project management are either present or being addressed. These elements include assessment of risk areas, action plans, schedules and timelines, and performance measures.

3.48 Several committees are involved in project management. For example, the Public Service Human Resources Management Agency of Canada, which is responsible for implementing the *Public Service Modernization Act*, has a project management committee. This committee oversees the approach to project management across all the central agencies involved in implementing pieces of the new legislation or supporting other initiatives. An interdepartmental project management committee has developed a generic project management plan to help departments implement the Act.

3.49 We found mechanisms in place to ensure that the priorities and plans for implementation projects are integrated across the human resource management agencies, and that resources are allocated by priority.

Management of the non-legislative initiatives has improved

3.50 Several non-legislative initiatives (initiatives that do not require legislation) have been under way since 2000. We conducted some preliminary audit work of these initiatives from fall 2002 to February 2003—the results of which caused us concern about their management. Our concerns included a lack of stated priorities, measurable goals, outputs, and outcomes for individual projects. Often, accountability for the projects was not specified, nor were the costs, timelines, and scheduled dates of completion of work. We shared our concerns with central agencies in May 2003 and, to a large extent, they have addressed those concerns.

3.51 We found that work plans were developed to manage many of the non-legislative reform projects under way. The work plans contain information that the individual reform projects lacked initially, including expected outcomes and outputs, accountability for the project, key milestones and expected completion dates, and the resources (human and financial) required to complete the work.

3.52 We also found that in developing the workplans for the non-legislative projects, priorities had been set and links made to legislative projects. For example, the development of a compensation planning framework is a non-legislative initiative that has links to a number of legislative elements. These include new PSMA requirements for compensation research, labour relations, and establishment of rates of pay on appointment. Links were also made among non-legislative reform projects; for example, classification reform is linked to reforms in areas such as labour relations, compensation, employment equity, and pay equity.

3.53 Together, these improved practices in project management encourage coherence and complementary relationships among the many legislative and non-legislative projects under way to modernize the management of human resources. Projects are not being carried out in isolation from one another.

Tracking costs is essential

3.54 The government has set aside $238 million in additional funding to implement the *Public Service Modernization Act*. At the time of our follow-up audit, about $38 million had been spent on early work and project management; the remaining $200 million will be managed through a strategic investment framework. Under the framework, money provided to departments will be based on the business cases they make to the Treasury Board for access to these funds.

3.55 This process is a good first step to control spending and allocate funding. However, we noted that some stakeholders are concerned about the adequacy of funding. The $238 million set aside will not pay for the total cost of implementing what will likely mean major cultural, organizational, and procedural changes in human resources management. Officials told us that departments will be expected to fund some of these modernization costs by reallocating funds internally. However, given that the government wants more than $12 billion over four years to meet its commitments to health care and other priorities, identifying funds for supporting human resources management changes internally could be a challenge.

3.56 In the past, we have noted problems in identifying and tracking the total amounts spent across government on various initiatives, above and beyond funds allocated specifically for those purposes. All the costs of modernizing human resources management—the legislative and the non-legislative reforms—need to be determined according to the principles of sound financial management and the government's Management Accountability Framework. The total cost will include various "soft" costs that departments must incur in areas such as training, information technology, conflict-management systems, and cultural change.

3.57 We note that the government did not identify and monitor the complete costs of two fairly recent initiatives: implementing a universal classification system and downsizing. We urge the government to track its expenditures on the reform of human resources management carefully. Doing so will make it possible both to assess the adequacy of current funding for implementing the PMSA and to determine the longer-term financial requirements of the reforms.

New dispute resolution agencies face challenges

3.58 A new organization, the Public Service Staffing Tribunal, will resolve staffing complaints. At this writing, no chairperson had been appointed to the Tribunal, although the position was advertised in October 2004, and we were told an appointment could be expected by January 2005. Once the head of the Tribunal is appointed, an organizational structure will have to be established and the organization staffed, and regulations and procedures will need to be developed and communicated to managers, employees, and unions.

3.59 Initially, 18 months was considered the timeframe needed for the tribunal to become operational. If a new head is appointed to the Tribunal in January 2005, under the present plans, the organization will have 11 months to become operational.

3.60 While some work has been done to develop the organizational structure for the Tribunal, we believe the timeframe for establishing the new organization is tight and any delay in appointing the head could jeopardize the date at which the new *Public Service Employment Act* comes into effect.

3.61 The legislation also creates the Public Service Labour Relations Board (PSLRB) for dispute resolution; essentially, a renamed Public Service Staff Relations Board with an expanded mandate and additional responsibilities. This part of the legislation is scheduled to become effective on 1 April 2005.

3.62 Most of the work required for the labour relations board to meet its new mandate has been done (for example, consultation and drafting of regulations, establishment of the new governance structure, preparation for new public interest commissions). But there is still concern about a couple of areas. A key aspect of the Board's new responsibilities is the establishment of a compensation research and analysis function that will provide information to both parties in collective bargaining to help them reach agreement on compensation. This function has not yet moved from conception to operational because of delays in receiving funding for its implementation and delays in creating an advisory board to provide advice to the chairperson on the compensation research and analysis services. Similarly, the PSLRB will be required to expand its existing mediation services considerably, and this aspect of work also needs incremental funding to progress. Funding was approved by the Treasury Board in October 2004, and the Staff Relations Board is taking the necessary steps to establish and enhance those services.

3.63 While the Public Service Staff Relations Board, as an independent quasi-judicial body, has remained separate from the overall management of the implementation of the legislation, we note that it had in place its own planning, project management, and control frameworks, as well as mechanisms for consultation with both employer and bargaining agents to ensure that it would be able to meet the requirements of the new *Public Service Labour Relations Act*.

Prerequisites for continuing success

3.64 In our view, the government has a good foundation for managing the legislative and non-legislative elements of the reform of human resources management. This represents an important change from the way two other such initiatives—PS 2000 and La Relève—were managed. Although much has been accomplished in a relatively short time, we do have some concerns. We believe that the government needs to address them if it is to maintain the present momentum of the reforms and ensure that it can implement them effectively in the coming years.

Human resources management is split

3.65 While the new *Public Service Modernization* Act consolidates the Treasury Board's role as employer, organizational decisions taken after the legislation was passed have split the human resources management functions among many stakeholders. As noted earlier, in December 2003, the government announced the creation of the Public Service Human Resources Management Agency of Canada, a separate organization reporting to the president of the Queen's Privy Council. In July 2004, the new Agency's reporting relationship was changed; it now reports to the president of the Treasury Board.

3.66 The December 2003 announcement indicated the possibility of transferring collective bargaining to Public Works and Government Services Canada after consultation with unions and the current round of negotiations. No further announcement on this point has been made; labour relations and collective bargaining remain the Treasury Board Secretariat's responsibility. Compensation planning, pension and benefits policies, and administration also remain with the Secretariat.

3.67 While the creation of the new Agency, headed by a president at the deputy minister level and focussed on human resources management, indicates more emphasis on the management of people—the government's key, and one of its most expensive, resources—the splitting of roles and responsibilities without compensating co-ordination mechanisms raises some concerns.

3.68 Our 2003 Status Report, Chapter 6, Reform of Classification and Job Evaluation in the Federal Public Service, noted that responsibility for three interrelated key functions—classification, compensation, and labour relations—was divided among three divisions in the Treasury Board Secretariat that worked independently. Because the classification of a job directly affects the salary, the management of these three functions is generally integrated, particularly in response to proposals for changes to a classification plan. In the rounds of negotiation leading to new classification plans, much work is often done to try and reduce the cost of any reforms. We noted in May 2003 that the separation of these three functions was hindering the Secretariat's efforts to reform the classification system. At the time, the Secretariat had recognized that clustering classification, compensation, and labour relations, along with pay equity, would allow for better information sharing and a more integrated approach to these functions.

3.69 We have been told of frequent consultations between the people responsible for collective bargaining in the Secretariat and the classification group at the Agency, but we did not find any formal mechanisms for aligning classification reform with collective bargaining. Given that there were problems when the divisions worked independently within one organization, dividing functions that are normally integrated between two separate organizations creates the potential for more difficulties. In our opinion, strong formal mechanisms for integrating and co-ordinating the efforts of the Secretariat and the Agency will be needed to overcome the effects of splitting human resource responsibilities.

3.70 The Agency retains responsibility for policies for learning and training, and for establishing professional development programs, while the Canada School of Public Service is the key arm for training and learning. Co-ordination between these two organizations will be critical to ensure that policy direction is carried out.

3.71 The Treasury Board is increasing its focus on financial management and implementing the Management Accountability Framework. This framework includes a key people component. Issues of human resources management thus become more complex, given the requirements of co-ordinating, managing, and assigning accountability for programs and activities that are split among different organizations.

3.72 Legislation introduced in Parliament in October 2004 would allow the Treasury Board to delegate to the president of the Public Service Human Resources Management Agency of Canada any powers over human resources management. The legislation also proposed that the president of the Treasury Board play a co-ordination role. In our view, the relationship between the Agency and the Secretariat (operating as the Treasury Board's general manager) needs to be clarified and communicated. Officials we spoke with indicated that they were not clear on the change in roles in the Secretariat and the Agency, where they should go for advice on various human resource issues and how the decision making processes were managed. Without further explanation of how human resource issues will be co-ordinated and managed in an integrated way, our previous concerns about the fragmentation of roles and responsibilities remain.

3.73 **Recommendation**. In carrying out the human resources role of the Treasury Board as the employer, the Treasury Board Secretariat and the Public Service Human Resources Management Agency of Canada should clarify how they will formally co-ordinate, integrate, and manage human resource functions and initiatives.

The Secretariat and the Agency's response. As recognized in Exhibit 3.3 and elsewhere in this chapter, a formal governance structure has been established to ensure the horizontal integration of plans and priorities, to identify corporate resources allocated to projects, and to monitor challenges and priorities. In addition to the formal mechanism, co-ordination, integration, and management occur on an informal basis and close working relations exist between the two organizations. The heads of these two organizations and the President of the Public Service Commission meet regularly to discuss *Public Service Modernization Act* implementation, other change initiatives, and requirements for mutual support. Similarly, at the working levels, frequent consultation occurs between the parts of the organizations involved in, and affected by, human resource management issues; for example, the organizations involved in classification and collective bargaining. Both organizations report to the president of the Treasury Board and constitute part of the Treasury Board portfolio. The secretary of the Treasury Board Secretariat is responsible for providing advice on the coherent policy development and management of his portfolio.

3.74 Under the new *Financial Administration Act*, the Treasury Board must report annually to Parliament on the discharge of its human resource management responsibilities and those of deputy ministers. In the past, we have called for more comprehensive reporting on human resources management.

3.75 However, with the management of these responsibilities split between two organizations (the Treasury Board Secretariat and the Public Service Human Resources Management Agency of Canada), it is imperative that these two organizations develop mechanisms to produce an integrated report. In addition, the Public Service Commission is to report on the health of the staffing system.

3.76 Department officials we spoke with expressed concern about possibly having to provide multiple reports to various bodies on different timelines, requiring similar but not identical information. While some preliminary work was done to develop integrated reporting through the Management Accountability Framework, this is an area where more work is needed.

3.77 Another concern is the need to establish meaningful performance measures now and gather benchmark data in order for the Treasury Board and the Public Service Commission to report on whether the new human resources management regime is meeting expectations. This is a critical step, particularly given the mandated five-year legislative review.

3.78 Work on a performance measurement and reporting framework has been started but is not yet complete. A mechanism for integrated reporting that does not unduly burden departments also needs to be established.

3.79 **Recommendation.** The Treasury Board Secretariat and the Public Service Human Resources Management Agency of Canada should produce regular integrated reports on the progress of reforms to human resources management against established performance measures, and these reports should include interim achievements with the ongoing costs of implementation. The Public Service Commission should also establish performance measures and report regularly on progress in implementing the new staffing regime.

The Secretariat and the Agency's response. We agree with the recommendation and work is well under way on the development of a performance measurement and reporting framework for the people component of the government's overall Management Accountability Framework (MAF). The Deputy Minister Human Resources Management Committee endorsed this component of the MAF on 26 October 2004. It describes the outcomes for sound people management in terms of both the workplace and the workforce. The Public Service Human Resources Management Agency of Canada is now focussing its work on developing the indicators, measures, and data sources that will permit the organization to determine progress on realizing these outcomes.

The Commission's response. The Commission supports the recommendation to establish performance measures and report regularly on progress in implementing the new staffing regime. This will be achieved through the Commission's Staffing Management Accountability Framework, which will set out the requirements, indicators, and measures to evaluate departmental performance in implementing the new regime.

Communications and learning

3.80 The government has recognized that effective communication will be crucial to successfully implementing these reforms. In the fall of 2003, several communication activities coincided with the passage of the new human resources management legislation. While efforts since then have focussed on policy and content development, various efforts have also been made to inform senior executives and departments about the coming changes. For example, the Public Service Commission led a consultative process in June 2004 with line managers and human resource professionals on issues relating to the implementation of the revised *Public Service Employment Act*. In September 2004, the Commission followed this with a conference for over 300 line managers and human resources professionals from across the country concerning various PSEA implementation issues. A further follow-up conference was planned for November 2004. The Public Service Human Resources Management Agency of Canada published a detailed information package on the full PSMA in July, with further elaboration sent out in October. This outlines mandatory requirements under the new acts (PSEA and PSLRA) as well as flexibilities that provide opportunities for doing things differently. The Treasury Board Secretariat planned meetings on changes under the *Public Service Labour Relations Act* for late 2004.

3.81 Although senior management is receiving information, we are concerned that more detailed information may not be circulating at lower levels in departments and, particularly, in the regions. In our view, a prerequisite to implementing the reforms effectively is ensuring that staff throughout departments are properly informed about them. As we were finishing our examination, work began at the Agency on a strategy to engage staff, starting at the assistant deputy minister level. We think much more work is needed to communicate with line managers, human resource professionals, unions, and employees if the PSMA is to be implemented successfully. The Agency indicated that it will intensify its communications in the fall of 2004.

3.82 We note that the Public Service Human Resources Management Agency of Canada, through the work of the various committees, has *identified training as a high-risk area that must be carefully managed at all levels.* The Agency, in collaboration with the Canada School of Public Service, is working to define the learning needed and is identifying knowledge gaps to develop appropriate, effective content for training programs. A learning strategy has been developed and the new Canada School of Public Service will design the training. This development was still in too early a stage for us to comment on its adequacy, but we recognize that much of the success of the reforms will rest on extensive training and communication.

Developing capacity in departments

3.83 If the government is to successfully modernize its human resource management systems, departments must have the capacity to implement the reforms as planned. This is a key concern that all stakeholders share. Cutbacks in the 1990s in areas such as human resources planning have left skill gaps in this area, now a key underpinning of new initiatives. The demographics of the human resources community indicate that some 47 percent of those professionals are eligible to retire by 2008, compared with 35 percent of the rest of the public service. In a recent report, the Public Service Commission noted possible shortages in the availability of people with the knowledge needed for human resources management at the department level.

3.84 The roles of both human resource professionals and line managers are changing. Human resource professionals will need to assume a role that is more strategic rather than transactional, as we noted in our 2001 Report, Chapter 3, Recruitment for Canada's Future Public Service: Changing the Practices, on recruitment. Line managers will have more responsibility and accountability for human resources. These shifts will be significant for many human resource practitioners and managers.

3.85 The lack of people with the right skills could hinder the government's efforts to translate the provisions of the PSMA into concrete reforms. We note the concern among all stakeholders that a lack of capacity could lead departments to revert to their old systems, stalling progress toward modernized human resources management.

3.86 One of the many implementation projects we noted involves developing criteria for assessing an organization's readiness for certain human resource management activities. The criteria need to be developed further, although the work to date is a reasonable first step toward measuring capacity to implement such reforms.

The need for sustained momentum

3.87 The government's priorities are continually evolving. Reforming human resources management is only one priority among many with which this initiative must compete. We believe it is essential to maintain momentum and ensure that modernization of human resources management remains a priority and an important element in the government's larger agenda. Only then will it be possible to institute reforms and embed them in the operations of government.

3.88 That this initiative will require a big cultural change makes it a particular challenge, one that will need sustained attention over more than five years. In the past, the government has had mixed success at maintaining a focus on long-term projects and keeping them a priority. We note also that many other change initiatives were launched at the same time, and the government is looking to reallocate its budget significantly.

3.89 Officials told us that the MAC would continue to exist after the legislation comes into force. However, it is not clear what other committee structure or mechanisms, if any, will be needed once that happens or what course corrections will be needed as implementation proceeds. Senior officials recognize that work is needed in this area.

Conclusion

3.90 We have described the many positive steps to manage both the implementation of new legislation and the supporting non-legislative initiatives the government has taken since our last Report in 2000 on reforming human resources management. One of the most important is the foundation it has put in place for managing this complex undertaking. We found leadership and a sense of purpose present. With some exceptions, the approach is integrated and emphasizes co-operation and co-ordination. We also note that the committees and working groups involved in implementing the *Public Service Modernization Act* and other reform initiatives have both identified the key risks and challenges to reforming human resources management and developed strategies for dealing with them.

3.91 Despite these efforts, the government will have to monitor progress constantly and be agile enough to make any changes needed to maintain steady progress. In our view, the government must maintain the momentum that has already been established to prevent the growth of cynicism in the public service and ensure that the reforms are implemented successfully.

3.92 We have recommended annual progress reports on reforms. Consideration of these reports by a parliamentary committee would be important as a means of influencing the nature, direction, and pace of change: an opportunity for Parliament to ensure that momentum is maintained and that change is real rather than illusory—and that Canadians are benefiting.

About the Follow-Up

Objective

We examined the management of implementation of the new legislation and continued our assessment of the progress on non-legislated modernization initiatives for human resources management.

Scope

Following our tabling of our April 2000 Report, Chapter 9, Streamlining the Human Resource Management Regime: A Study of Changing Roles and Responsibilities, the government initiated several projects to modernize human resources management. This included the tabling of Bill C-25, the *Public Service Modernization Act*, and numerous non-legislative initiatives.

We examined the management and support provided for implementation of the new legislation. We also updated our work on how the non-legislated modernization initiatives contribute to the stated strategic objectives for human resources management and how they are being managed, co-ordinated, and integrated with legislative changes. We looked, for example, at the objectives of these initiatives, the rationale supporting them, their status and priority, the resources required, their timetable, and other costs, as appropriate. We also looked at the government's capacity to move on a number of fronts, to select priorities, and to assign resources to make the necessary organizational adjustments.

Our work consisted of interviews and reviews of documentation mostly in the Privy Council Office, the Treasury Board Secretariat, the Public Service Commission, the Canada School of Public Service, the Public Service Human Resources Management Agency of Canada, and the Public Service Staff Relations Board.

Criteria

Criteria for this component of the follow-up were drawn from several sources, including past Office of the Auditor General reports and studies, particularly Chapter 9 of the April 2000 Report.

Our criteria consisted of the following:

- The roles and responsibilities of central agencies and deputy ministers for managing human resources are clarified by the new legislation.
- The implementation of the new legislation is supported and managed effectively.
- Clear plans and accountabilities are in place to ensure the achievement of non-legislative modernization initiatives that support a streamlined and simplified human resources management regime.

Audit team

Assistant Auditor General: Shahid Minto
Principal: Kathryn Elliott
Director: Claude Brunette

Robyn Roy

For information, please contact Communications at (613) 995-3708 or 1-888-761-5953 (toll-free).

Appendix Excerpt from the *Public Service Modernization Act*

Summary

Part 1 enacts the *Public Service Labour Relations Act* to provide for a labour relations regime in the public service which is based on greater cooperation and consultation between the employer and bargaining agents, notably by requiring labour-management consultation committees, enabling co-development, enhancing conciliation and providing for negotiated essential services agreements. This new Act eliminates certain managerial and confidential exclusions and brings unfair labour practices up-to-date. It provides for the establishment of conflict management capacity within departments and more comprehensive grievance provisions. It also establishes the Public Service Labour Relations Board whose mandate is to provide adjudication services, mediation services and compensation analysis and research services.

Part 2 amends the *Financial Administration Act* to put direct responsibility for certain aspects of human resources management in the hands of deputy heads, subject to policies and directives of the Treasury Board. New deputy head responsibilities include determining learning and developmental requirements, providing awards and setting standards of discipline. Part 2 also amends that Act to provide for annual reporting to Parliament by the President of the Treasury Board on the application of the human resources management provisions of the Act.

Division 1 of Part 3 enacts a new *Public Service Employment Act* to modernize staffing in the public service while retaining the core values of merit, excellence, non-partisanship, representativeness and the ability to serve members of the public with integrity in the official language of their choice. The Act gives a new meaning to merit and creates new arrangements for staffing recourse, one of the features of which is the Public Service Staffing Tribunal. The Public Service Commission will continue to conduct investigations and audits on matters within its jurisdiction. The Act establishes, in addition to the annual reporting by the Public Service Commission, a requirement for the President of the Treasury Board to report annually to Parliament on the Treasury Board's responsibilities under the Act.

Division 2 of Part 3 amends the existing *Public Service Employment Act* to permit certain elements of the new Act to come into force sooner. The amendments establish a new Public Service Commission to administer the existing Act and to prepare the regulatory and policy framework for the new Act. They also establish a new Public Service Staffing Tribunal to prepare for the coming into force of the new Act and establish a new regime governing the political activities of public servants in a manner that balances their right to engage in those activities while maintaining the principle of political impartiality in the public service.

Part 4 amends the *Canadian Centre for Management Development Act*, which becomes the *Canada School of Public Service Act*. The School becomes responsible for learning and development activities for employees in the public service.

Chapter

4

Accountability of Foundations

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Accountability of Foundations

Main Points

4.1 Despite a number of improvements to the framework for the accountability of foundations to Parliament, overall progress is unsatisfactory. Important gaps remain in the external audit regime and in ministerial oversight, two of the three areas examined in this audit. There is no provision for performance audits of foundations that are reported to Parliament. Nor do mechanisms for ministerial oversight adequately provide for the government to make adjustments in foundations where circumstances have changed considerably.

4.2 Improvements have been made in reporting to Parliament and the public, the third area examined in this audit. The government is committed to better reporting in foundations' corporate plans and summaries and their annual reports, and in the Estimates reports of sponsoring departments. However, performance information remains insufficient for parliamentary scrutiny and needs improvement.

4.3 There are inconsistencies in the governance regime for foundations. The independence of foundations still poses risks for reporting and ministerial oversight, and the application of the transfer payment and alternative service delivery policies is unclear.

Background and other observations

4.4 In 1997, the government introduced a new approach to achieving policy objectives by transferring public funds to foundations—non-profit corporations considered to be at arm's length from the government. In our sample, three foundations were established by direct legislation and the others were established under provisions such as the *Canada Corporations Act*. At 31 March 2004, more than $9 billion in grants had been paid to foundations.

4.5 In the Auditor General's observations on the government's summary financial statements in the Public Accounts of Canada, we have raised concerns about the governance and the accountability of and accounting for government transfers to foundations. These are up-front payments made many years in advance of need. Our performance audits in 1999 and 2002 found that accountability to Parliament was placed unnecessarily at risk—the government had failed to meet the essential requirements for accountability to Parliament, namely credible reporting of results, effective ministerial oversight, and adequate provision for external audit.

4.6 In Budget Plan 2003, the government announced improvements in the accountability of foundations, commitments that it repeated in Budget Plan 2004. In this follow-up audit, we examined the progress it had made.

4.7 This chapter does not express a view on the merits of foundations as a vehicle to achieve the government's policy objectives. Our findings should not be interpreted in any way as a criticism of the individuals in charge of the foundations.

The government has responded. The Treasury Board of Canada Secretariat's response, on behalf of the government, disagreed with our conclusion that overall progress has been unsatisfactory and with our recommendation that the Auditor General, with a few exceptions, be appointed as external auditor of foundations. The government recognized the need for further improvement in a number of areas and expressed a willingness to explore the areas of disagreement to see if solutions that respect the independence of foundations and overall policy objectives can be identified.

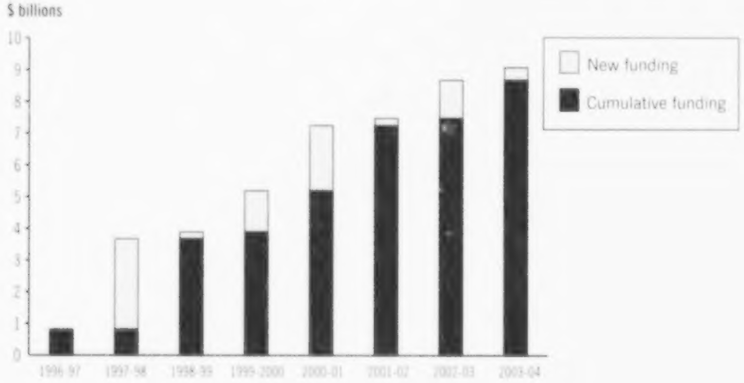
Introduction

4.8 In Budget Plan 2003 (Appendix A), the government referred to foundations as a new approach to meeting the needs of Canadians:

> Foundations use up-front endowment funding and independent arm's-length boards of directors made up of experienced and knowledgeable individuals … foundations have become important tools for implementing policy…

4.9 From 1996–97 to 2003–04, the government transferred more than $9 billion to foundations—$1.2 billion in 2002–03 alone and $400 million in 2003–04 (Exhibits 4.1 and 4.2). These are up-front payments made many years in advance of need. With transfers of this magnitude, concerns about the accountability of foundations have grown. This audit examined 6 sponsoring departments in relation to 11 foundations (Appendix B).

Exhibit 4.1 Transfers to foundations



Source: Public Accounts of Canada

4.10 Accounting for transfers to foundations and accountability are long-standing issues. Our Office first raised concerns in 1997. Since then, both we and the Standing Committee on Public Accounts have made recommendations to the government, and Parliament has shown a growing interest in these issues (Exhibit 4.3).

4.11 The Budget plans 2003 and 2004 contained commitments to improve the accountability of foundations. The government noted that the improvements are to be implemented on a "going forward" basis—that is, they are to be implemented for new foundations or through amended funding agreements for existing ones. The government stated that it would consult with foundations to explore the incorporation of its new commitments in existing funding agreements.

Exhibit 4.2 Summary financial information on foundations, 1996–97 to 2003–04

Foundation[1]	Year announced	Funding received[2]	Grants provided[3]	Interest earned	Administration	Balance 31 March 2004[4]	Funding commitments signed[5]
	($ millions)						
Canada Foundation for Innovation	1997	3,651	1,230	740	39	3,122	1,529
Canada Millennium Scholarship Foundation[6]	1998	2,500	1,155	690	47	1,988	9
Canada Health Infoway Inc.	2001	1,200	51	83	30	1,202	42
Endowment Funds[7]	Between 2000 and 2002	389	10	48	11	416	104
Genome Canada	2000	375	188	52	19	220	198
Aboriginal Healing Foundation	1998	350	241	86	43	152	139
Sustainable Development Technology Canada	2001	350	6	10	7	347	37
Canadian Health Services Research Foundation	1997	152	37	14	7	122	21
Other foundations under $125 million[8]	Between 2000 and 2002	120	36	13	4	93	16
Total		**9,087**	**2,954**	**1,736**	**207**	**7,662** [9]	**2,095**

[1] The foundations reflected in this table have each received over $10 million in total funding from the government since 1997, specifically for spending in a future year more than a year ahead.

[2] Transfers include $100 million announced in the March 2004 Budget that were receivable by the foundations at 31 March 2004.

[3] In addition to grants, this column includes eligible project expenses.

[4] These balances are at the date of the latest annual reports, where 31 March 2004 financial statements are not yet available—modified to include the $100 million announced in the March 2004 Budget.

[5] Figures are based on representations from foundations, where not disclosed in their financial statements.

[6] The $9 million reported is related only to the excellence awards. As at 31 December 2003, the Foundation was committed to pay bursaries of approximately $250 million during 2004.

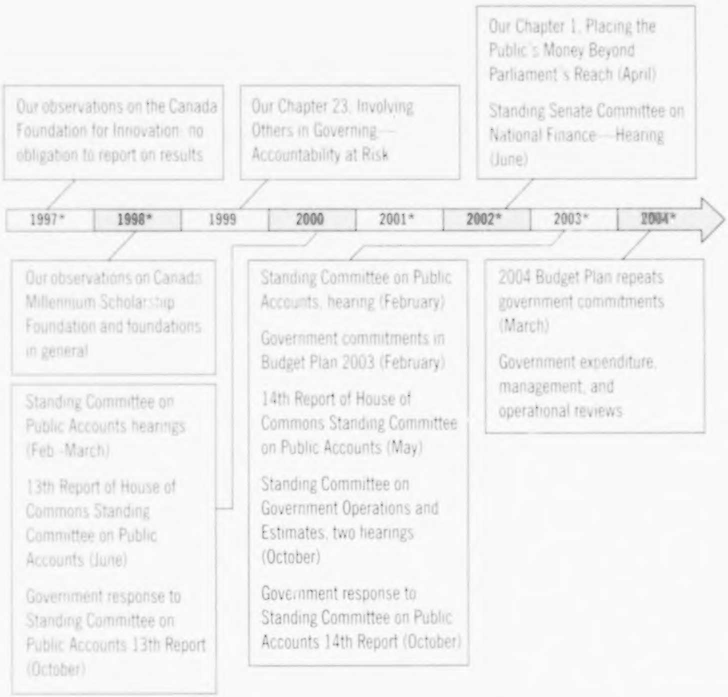
[7] For endowment funds, only the earnings are disbursed: these include Green Municipal Investment Fund; Pierre Elliott Trudeau Foundation; Clayoquot Biosphere Trust Society; Pacific Salmon Endowment Fund Society; Canadian Institute for Research on Linguistic Minorities; University of Moncton; and Frontier College Learning Foundation.

[8] These are Foundation for Climate and Atmospheric Sciences and Forum of Federations.

[9] In addition to funding for foundations and endowments, $550 million had been transferred to other organizations at arm's length from the government. $391 million of the transferred amount had yet to be used at 31 March 2004. These organizations are Canadian Institute for Health Information; Green Municipal Enabling Fund; Precarn; Canadian Network for Advancement of Research, Industry and Education; Canadian Institute for Advanced Research and Canadian Centre for Learning.

Source: Adapted from Public Accounts of Canada 2004

Exhibit 4.3 Concerns about foundations have grown


Our observations on the Canada Foundation for Innovation: no obligation to report on results
Our Chapter 23, Involving Others in Governing—Accountability at Risk
Our Chapter 1, Placing the Public's Money Beyond Parliament's Reach (April)
Standing Senate Committee on National Finance—Hearing (June)
1997*
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2004*
Our observations on Canada Millennium Scholarship Foundation and foundations in general
Standing Committee on Public Accounts hearings (Feb.-March)
13th Report of House of Commons Standing Committee on Public Accounts (June)
Government response to Standing Committee on Public Accounts 13th Report (October)
Standing Committee on Public Accounts, hearing (February)
Government commitments in Budget Plan 2003 (February)
14th Report of House of Commons Standing Committee on Public Accounts (May)
Standing Committee on Government Operations and Estimates, two hearings (October)
Government response to Standing Committee on Public Accounts 14th Report (October)
2004 Budget Plan repeats government commitments (March)
Government expenditure, management, and operational reviews

* Our observations on the Financial Statements of the Government of Canada: accounting for transfers and accountability of foundations in the Public Accounts of Canada

4.12 In 2004 the Treasury Board Secretariat of Canada asked the Auditor General for input to its management and operational reviews, including the review of governance in Crown corporations and other government institutions. We reinforced our concerns about the lack of a comprehensive governance and accountability framework for foundations and encouraged the government to develop an appropriate regime—for example, by considering the findings in our April 2002 Report.

Accounting issues

4.13 Since 1997–98, the Auditor General's observations on the government's summary financial statements in the Public Accounts of Canada have raised concerns about how the government accounts for transfers to foundations.

4.14 The government has recorded these payments as expenses, even though the foundations do not expect to use the funds for many years. At 31 March 2004, nearly $7.7 billion of these funds were still in the foundations' bank accounts and investments, earning interest. This accounting treatment has resulted in a reduction of the reported annual surplus when funds are transferred to foundations, rather than when funds are distributed to the ultimate intended recipients or used for the ultimate purposes that the government announced for this spending.

4.15 While we have questioned the government's accounting for these transfers, we cannot state unequivocally that the government's method of accounting for foundations contravenes the accounting standards established by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants. We have therefore continued to issue unqualified opinions on the government's summary financial statements, while raising this as an "Other Matter" in the Report of the Auditor General on the financial statements of the Government of Canada.

4.16 To resolve this outstanding disagreement, we have looked to developments in accounting standards; specifically, we have been following the progress of two relevant PSAB projects.

4.17 The accounting standard recently issued by the PSAB for implementation in 2005–06 provides guidance on determining whether an organization is controlled by the government. If the foundations were deemed to be controlled by the government pursuant to this new standard, then payments to them could not be recorded as expenses, since the foundations would then be considered to be within the government reporting entity. We are currently discussing the implications of this PSAB standard with officials of the Treasury Board Secretariat.

4.18 We are also continuing to monitor progress on a second PSAB project, which seeks to revise guidance on accounting for government transfer payments, including multi-year funding.

4.19 The Auditor General's observations on the government's financial statements in the 2003–04 Public Accounts of Canada have noted the link between accounting issues and the need to improve accountability:

> The accountability and governance structures for the foundations may be influenced by the desire to ensure that transfers to foundations can be treated as expenses immediately, rather than when these funds are used by the foundations for their ultimate purposes. In my view, decisions on funding and accountability should be based on the need for sound management of public funds; they should not be based on the goal of achieving a desired accounting result.

Focus of the follow-up

4.20 Our audit examined selected departments that sponsor foundations (Exhibit 4.4), including their action on the government's commitments and our previous recommendations in three areas: reporting to Parliament and the public, ministerial oversight, and provision for external audit and evaluation. Our objectives were to assess the extent to which the government, central agencies, and sponsoring departments have acted to improve the accountability of government-sponsored foundations to Parliament and the implications for the accountability framework presented in Chapter 1 of our April 2002 Report (Appendix C).

4.21 We looked for improvements in accountability in a number of areas, including the extent to which the government's Budget commitments adequately addressed our recommendations and those of the Standing Committee on Public Accounts; whether provisions were introduced with respect to these recommendations; and, where provisions exist, what actions had been taken.

4.22 On 15 November 2004, the government tabled Bill C-21, with the objective of modernizing the governance framework for federal not-for-profit corporations. Several of the foundations that are mentioned in this audit will be subject to the new regime. However, the amendments proposed by this bill

Exhibit 4.4 Sponsoring departments selected for audit, and government funding to foundations

Sponsoring departments and foundations	Previous Auditor General reports	Total funding 31 March 2004 ($ millions)
Natural Resources Canada and Environment Canada		
Sustainable Development Technology Canada	2002	350
Green Municipal Investment Fund*	2002	200
Green Municipal Enabling Fund*	2002	50
Industry Canada		
Genome Canada	2002	375
Canada Foundation for Innovation	1999 & 2002	3,651
Pierre Elliott Trudeau Foundation	Not applicable	125
Canadian Institute for Advanced Research	Not applicable	25
Health Canada		
Canada Health Infoway Inc.	2002	1,200
Canadian Health Services Research Foundation	1999 & 2002	152
Human Resources and Skills Development Canada		
Canada Millennium Scholarship Foundation	1999 & 2002	2,500
Indian and Northern Affairs Canada**		
Aboriginal Healing Foundation	Not applicable	350

* Federation of Canadian Municipalities administers these funds
** The sponsoring department is now Indian Residential Schools Resolution Canada

Source: Public Accounts of Canada 2001–02 to 2003–04 inclusive do not address our concerns about the lack of performance audits and an appropriate mechanism for ministerial oversight.

4.23 More details on the audit objectives, scope, approach, and criteria are found in **About the Follow-Up** at the end of the chapter.

Observations and Recommendations

4.24 In our 2002 audit, we noted that both foundations and granting councils (for example, the Natural Sciences and Engineering Research Council of Canada) redistribute public money for a variety of purposes, at arm's-length from the government. Unlike the granting councils, foundations are not answerable to Parliament through a minister. The government achieves public policy objectives through foundations. However, the foundations are independent corporations in law, which, in our view, raises the question of how the government can be held to account for the transferred funds.

Reporting to Parliament and the public

Provisions for corporate plans and annual reports have improved

4.25 All the foundations in our sample, except for the Aboriginal Healing Foundation and the Canada Millennium Scholarship Foundation, are now required by their funding agreements to provide corporate plans each year to sponsoring ministers. With respect to ministers tabling corporate plans or summaries in Parliament, only the Canada Foundation for Innovation (CFI) has such a provision. However, the CFI corporate plan summary was tabled by the minister in Parliament as part of the CFI annual report. In our view, corporate plans or summaries should be tabled separately to allow timely consideration.

4.26 In 2003 all the foundations in our sample submitted their annual reports to sponsoring ministers and made them public. However, only five of these annual reports were tabled in Parliament by sponsoring ministers, including the three foundations that are required to do so by legislation (Canada Millennium Scholarship Foundation, Canada Foundation for Innovation, and Sustainable Development Technology Canada).

Performance information can be improved

4.27 We examined the information in the corporate plans and annual reports of the foundations included in our audit. Most foundations provided information on how much money was spent and how many projects were funded. Improvements are needed, however, with respect to information on the results achieved by the foundations.

4.28 Some efforts are underway to improve performance reporting, including the following:

- The Treasury Board Secretariat is developing a government-wide framework for reporting on federally supported climate change activities and has invited the Green Municipal Funds and Sustainable Development Technology Canada to participate.

- The Green Municipal Funds introduced a set of performance indicators in their *2003–2004 Annual Statement of Plans and Objectives* and a Project Performance Reporting System that required all project applicants to quantify their environmental results in a consistent reporting framework.

Further efforts are needed to improve information on results.

4.29 **Recommendation.** Sponsoring ministers should table in Parliament the corporate plans or summaries and the annual reports of foundations in a timely manner. In consultation with the foundations, the sponsoring departments should encourage them to include meaningful information on results in their plans and reports.

Government's response. We agree with the Auditor General's conclusion that improvements have been made in reporting to Parliament and the public.

In Budget Plan 2003, the government committed to undertaking a number of measures to improve the provision of information to Parliament on the plans and results of foundations. All statutory reporting requirements to Parliament are being met. For many years now, ministers have tabled the annual reports of foundations in Parliament, representing 80 percent of all transfers to foundations. To the extent there are other significant foundations whose reports are not tabled in Parliament, the Treasury Board Secretariat will encourage departments to do so.

In addition, departments are required to report on the significant plans and results of foundations in their reports on plans and priorities and departmental performance reports. They are also required to situate these within the overall plans and results of the department. This horizontal reporting requirement exceeds the expectations of the Auditor General. The Treasury Board Secretariat has issued guidelines on these reporting requirements.

The government believes a considerable amount of information on plans and results is available through these reports tabled in Parliament and the Web sites of both departments and the foundations. Opportunities therefore exist for the engagement of ministers and the foundations. As an example, many foundations have appeared before parliamentary committees.

Nevertheless, the government acknowledges that further improvement in the quality and comprehensiveness of reporting on foundation plans and results can be made, and it undertakes to do so.

Reporting by sponsoring departments

Insufficient information for Parliament

4.30 Additional transfers of funds by government to foundations are often in larger amounts than the initial grant (Exhibit 4.5). This indicates the need for good information in the Estimates documents each year. However, the independence of foundations raises the concern that sponsoring departments may not always be able to obtain the necessary information for Parliament.

4.31 The Treasury Board transfer payment policy, which came into effect in June 2000, requires sponsoring departments to report to Parliament on transfer payments exceeding five million dollars. They must include information such as objectives and expected results in reports on plans and priorities, and evidence of related results achieved in departmental performance reports. Budget Plan 2003 reinforced these requirements, and it added that sponsoring departments are expected to situate the information on foundations in the context of their overall priorities and results, a commitment that went beyond our recommendations in 2002.

Exhibit 4.5 Examples of the flow of government funding to foundations

Foundation	Initial funding	Second payment	Third payment	Fourth payment	Fifth payment
	$ millions (fiscal year of payment)				
Genome Canada	160 (1999–2000)	140 (2000–01)	75 (2002–03)	-	-
Canada Foundation for Innovation	801 (1996–97)	200 (1998–99)	900 (1999–2000)	1,250 (2000–01)	500 (2002–03)
Canada Health Infoway Inc.	500 (2000–01)	600 (2002–03)	100 (2003–04)	-	-

Source: Public Accounts of Canada 2001–02, 2002–03; Budget plans 2003 and 2004

Outcomes were not adequately reported

4.32 Our review of Estimates documents tabled since our last audit (reports on plans and priorities for 2002–03 to 2004–05 and departmental performance reports for 2001–02 to 2003–04) suggests that improved reporting will take more time. We found more information each year on foundations in the Estimates documents of all the sponsoring departments. The information focussed mainly on the foundations' expenditures and activities or on broad objectives that in many cases were not measurable. The outcomes or benefits for Canadians resulting from the billions of dollars transferred to foundations were not adequately reported. One exception was Environment Canada. Although many of the actual results for projects funded by the Green Municipal Funds will not be known for some time, the Department has begun to report estimated figures on the key environmental impacts the projects will achieve.

Need to integrate reporting on results of foundations and sponsoring departments

4.33 We noted that as part of their commitment to undertake independent evaluation, nine foundations in our sample have developed evaluation or results-based management and accountability frameworks. These frameworks have the potential to help the foundations implement results-based management and eventually report on results.

4.34 Foundations often are not the only government-funded entities in a public policy area. For example, when Genome Canada and the Canada Foundation for Innovation were created in Industry Canada's portfolio, Technology Partnerships Canada was already a special operating agency in the Department. All three organizations distribute public funding to improve Canada's innovation performance.

4.35 In their Estimates documents, most sponsoring departments do not show the links between their results and those of foundations where they both deliver in a common public policy area. Such links are needed for sponsoring departments to integrate foundations' expected and actual results with their own overall priorities and results.

4.36 **Recommendation.** Sponsoring departments engaged in public policy areas that involve foundations should, in consultation with foundations, develop frameworks for reporting that link to the way the foundations measure and report results.

Government's response. The horizontal integration of public policy is a key priority of the government. As acknowledged by the Auditor General, considerable effort and progress has been made in developing results-based management and accountability frameworks. Following the commitment made in Budget Plan 2003, some departments now have the ability to undertake evaluations that can assess the horizontal integration of their programs with those of the foundations. Further efforts will be made to undertake these evaluations and to ensure effective integrated reporting on results to Parliament.

External audit and evaluation

Disagreement on performance audit

4.37 The external audit regime for foundations does not include provision for performance audits that are reported to Parliament. The government has not made a commitment in this regard. In its 14th Report, the Standing Committee on Public Accounts recommended that for those foundations either created through legislation or receiving significant federal funding (at least $500 million), the federal government

- seek amendments to the funding agreements to provide for periodic program evaluation, value-for-money audits, and independent assessment of the fairness and reliability of the performance information…; and
- appoint the Auditor General of Canada as external auditor of these foundations.

The government disagreed with these recommendations and, by implication, our similar recommendation.

4.38 The government responded:

> Requiring foundations to accept the public sector-type standards and operations as well as establishing the Auditor General of Canada as their auditor…could undermine the independence of the foundations, reduce their operational flexibility and organizational effectiveness and thereby reduce their usefulness in achieving the government's policy objectives… It is the responsibility of foundation members to appoint their external auditor and [the authority] to whom the external auditor reports. It should be left to foundations to determine whether to establish such measures as value-for-money audit, independent assessments of the "fairness" of the information presented in reports, or the selection of the Auditor General of Canada as their auditor.

4.39 In Budget Plan 2003, the government stated that foundations will be subject to independent evaluations, comprehensive performance reporting, and compliance audits of the use of federal funding and that these would cover most of the expectations relating to value-for-money (now performance) audits.

4.40 The government has transferred billions of dollars to foundations to achieve its policy objectives. In receiving these up-front transfers, foundations are effectively exempted from the kind of periodic scrutiny by Parliament that occurs when funds are appropriated annually. Once taxpayers' money is transferred to a foundation, the government relies on the foundation's directors and members to achieve public policy objectives.

4.41 Given the magnitude of these transfers, the public policy purposes involved, and the reduced opportunities for parliamentary scrutiny, the existing provisions for audit and evaluation in funding agreements with foundations are not adequate. In our view, performance audit is needed to provide Parliament with information and assurance on due regard for economy and efficiency; on procedures to measure and report on effectiveness, environmental effects, propriety, compliance with authorities, and adequacy of internal controls; and on verification of performance information. The Auditor General is well placed to conduct this work. However, where foundations involve provincial or territorial governments, or where the federal government is not a major contributor, other audit arrangements may be more appropriate.

4.42 In October 2003, the Standing Committee on Government Operations and Estimates, whose mandate includes the review of foundations, held hearings at which government officials, the Auditor General, and the heads of a number of foundations appeared as witnesses. A member of the committee asked foundation officers what problems would be caused if a foundation were subject to audit by the Auditor General, access to information law, and reporting to Parliament through a minister. Committee members agreed that foundations should respond in writing to these questions. We would welcome such responses to the Standing Committee on Government Operations and Estimates.

4.43 **Recommendation.** The federal government should ensure that foundations are subject to performance audits that are reported to Parliament. The Auditor General should be appointed as the external auditor of foundations, with a few exceptions.

Government's response. The government believes that the current framework, including the independent audit of the foundations' financial statements, compliance audit, independent evaluation, and comprehensive performance reporting in annual reports, already addresses most of the expectations relating to performance (value-for-money) audit. Nevertheless, the government will undertake to encourage foundations to implement performance audit regimes where appropriate.

It may be possible, with the agreement of foundations, for performance audits to be undertaken as an extension to the scope of the compliance audit provisions of existing agreements. Such audits could be undertaken by the external auditors or internal auditors, or, at the discretion of the relevant minister, a request may be made to the Auditor General to perform this work. Professional standards, such as those of the Canadian Institute of Chartered Accountants, exist to guide such audits.

It should also be noted that the framework that exists is similar to that for many other federal transfer payments to other governments, not-for-profit organizations, and businesses. As with these programs, the Auditor General has similar abilities to undertake performance audits and report these to Parliament.

With respect to the appointment of their external auditor, the government believes that the independence of these not-for-profit organizations and the requirements of their incorporation demand that this decision be left to the membership. Existing legislation and assurance auditing standards require the appointment of professionally accredited auditors. These provide assurance to all stakeholders as to the integrity and the reliability of the financial statements of these organizations.

The government believes that it is generally appropriate for the Auditor General, as Parliament's auditor, to be the auditor of most, if not all, federal government entities. Foundations are independent from and external to the federal government. As such, it believes the appointment of their external auditor should remain a fundamental right of the membership of these organizations, as it is for all private not-for-profit sector organizations. It should also be noted that it is not necessary to be appointed external auditor of an organization in order to have the ability to undertake an audit of the use of federal funding.

Need for evaluation standards

4.44 The foundations set their own terms of reference for evaluations required by funding agreements. In our view, consistent application of evaluation standards is needed to assess whether foundations have met the major government objectives set for them. Departments follow the standards set out in the Treasury Board's evaluation policy. Comparable standards could be used by foundations. This is a new element in our accountability framework for foundations (Appendix C).

4.45 We did not examine the evaluations or related documents commissioned by foundations but did find some good practices; for example, some foundations have asked officials in sponsoring departments to comment on evaluation documents such as draft terms of reference.

4.46 **Recommendation.** In new or amended funding agreements, sponsoring departments should seek to ensure that evaluations commissioned by foundations meet recognized evaluation standards.

Government's response. The government agrees that foundations should use recognized evaluations standards. However, it is very important to note that the Auditor General did not examine the evaluations or related documents commissioned by foundations and, as such, is not suggesting that such standards are not being followed. It is also important to note that departments are already obliged to follow the Treasury Board Evaluation Policy in the conduct of their evaluations.

Progress by sponsoring departments and foundations in evaluation

4.47 We found that 10 of the 11 funding agreements between sponsoring departments and foundations in our sample have provisions for independent evaluations. We did not expect evaluation studies to be available for more recently established foundations, such as Sustainable Development Technology Canada. In general, foundations have scheduled dates for evaluation and are meeting them. For example, in May 2003 the Canada Millennium Scholarship Foundation completed the five-year review mandated in its legislation. This report was tabled in Parliament in November 2003. Some foundations have included significant evaluation findings in their annual reports. We noted that the Aboriginal Healing Foundation has voluntarily undertaken three evaluations.

Provisions for compliance audit but little action

4.48 With respect to its commitment for independent compliance audits, the government indicated that these audits could be undertaken by departmental internal auditors, external auditors, or the Auditor General.

4.49 We found that eight funding agreements gave sponsoring ministers the authority to undertake compliance audits, but none was planned or underway at the time of our audit. We also noted that three foundations, the Green Municipal Investment Fund, the Green Municipal Enabling Fund, and the Aboriginal Healing Foundation, had undertaken their own compliance audits and review of the funding agreement. In addition, the Canada Health

Infoway Inc. funding agreement requires an annual compliance audit by an independent third party, and the first of these has been completed.

Financial audit information is being provided

4.50 All the foundations in our sample have provisions for a financial statement and a report by an external auditor who is appointed by the board or members of the foundation. The annual reports of the foundations included audited financial statements, prepared in accordance with Canadian generally accepted accounting principles.

Ministerial oversight

4.51 We expected to see mechanisms that would allow sponsoring departments to make adjustments if foundations did not perform as expected or if circumstances changed considerably. Such oversight typically requires strategic monitoring to gather more information than is contained in annual or other reports. The Budget plans announced commitments to include provisions for ministerial intervention in the event of significant deviation from the funding agreement, and for dispute resolution. These commitments deal with only part of our recommendations on ministerial oversight (Appendix D). There was no commitment by the government to introduce a mechanism to make adjustments in the face of changing circumstances.

Mechanisms are needed to allow positive adjustments

4.52 At present, with some exceptions, the government typically introduces adjustments by amending the existing funding agreement when it provides additional funding to a foundation. For example, when additional funds were provided to Sustainable Development Technology Canada and the Canada Foundation for Innovation, the funding agreements were amended to expand the project eligibility criteria to reflect changes in government policy.

4.53 As we recommended in 2002, an adjustment mechanism is needed to allow sponsoring ministers and their departments to intervene when a foundation is clearly not meeting its purpose or when circumstances in a specific public policy area have changed considerably since its creation. Such a mechanism would ensure that foundations do not work at cross-purposes with sponsoring departments. The adjustment mechanism should not rely on the allocation of additional funding and revisions to the funding agreement.

New provisions for extreme situations

4.54 All the funding agreements in our sample have provisions to deal with extreme situations such as default or the foundation breaking the agreement. The agreements define default (for example, false or misleading representation and information, or any significant failure in performance and/or compliance) and prescribe the procedures for remedies and/or arbitration. All the foundations in our sample also have dispute resolution clauses in their funding agreements.

4.55 Some funding agreements give the government authority to terminate the agreement if defaults are not remedied to the satisfaction of the sponsoring minister. Furthermore, as we recommended in our 2002 Report, most funding agreements now contain a right for the minister to recover unspent public funds on winding up the foundation.

Some good practices in strategic monitoring

4.56 Departmental officials have attended board meetings of some foundations as observers and have established procedures to obtain and comment on information and documents presented to boards. There are also arrangements for departmental officials to sit on foundations' advisory boards, audit and evaluation committees, and other governance bodies.

4.57 Industry Canada officials told us that in addition to attending such meetings, they have regular contact and consultations with, for example, the Canada Foundation for Innovation and Genome Canada. They stated that this approach lets them play an effective role in strategic monitoring and the prevention of disputes. We also noted examples of good practices with the Green Municipal Funds and Sustainable Development Technology Canada (Exhibit 4.6).

Exhibit 4.6 A good practice in strategic monitoring

The Green Municipal Funds (Green Municipal Enabling Fund and Green Municipal Investment Fund) are administered by the Federation of Canadian Municipalities (FCM) and, as such, are unique in our sample.

The Funds are co-sponsored by Environment Canada and Natural Resources Canada. Although the FCM's National Board of Directors is the formal and final authoritative body governing the Funds, the Board is advised by the 15 member Green Municipal Fund Council. Five of the council members are federal employees: currently, two are from each sponsoring department and one from Transport Canada. They act as a unified voice for the federal government, are briefed on the government's position on specific issues, and can intervene to influence decisions if necessary.

The federal members of the council also have an opportunity to review and comment on draft documents, such as the corporate plan and the annual report, prior to their publication. They also receive quarterly updates on the Funds' performance indicators, information that is then provided to federal departments.

The procedures have been formalized in a memorandum of understanding between the two sponsoring departments.

Central agency roles

4.58 We expected leadership from central agencies, in working with sponsoring departments, to improve the accountability framework for foundations and to implement Budget plan commitments.

4.59 In our 2002 Report, we recommended that the Privy Council Office (PCO) ensure that legislation to establish foundations met the essential requirements for good governance and accountability to Parliament, and that departments had fully defined the roles and responsibilities of federal appointees to foundation boards. The PCO did not indicate that it planned to take any action in response to our recommendations directed to it.

4.60 Although we did not make any recommendations to Finance Canada, our 2002 audit recognized the Department's role in the Budget process with respect to the levels of funding provided to foundations. Finance Canada elaborated on this role but referred most of our questions about the Budget plan commitments to the Treasury Board Secretariat.

The Treasury Board Secretariat needs to clarify the policy framework for foundations

4.61 **Policy on transfer payments.** We recommended that the Treasury Board Secretariat review the use of exemptions to the transfer payments policy that allow payments to be made to foundations in advance of need; it has planned no such review. We believe that paying more than $9 billion in advance of need could limit the flexibility of future parliaments and governments to respond to changing circumstances and priorities.

4.62 The transfer payment policy does not define "conditional grant," the type of transfer payment used for foundations. Treasury Board Secretariat officials informed us that the specific policy on conditional grants is under development and may be included in the revised policy on transfer payments. The officials also indicated that the policy direction for sponsoring departments was provided in Budget Plan 2003, in remarks by Secretariat officials before parliamentary committees, in guidance to departments, and in their publications.

4.63 **Policy on alternative service delivery.** The Budget plans state that the policy principles (Appendix A) are consistent with the alternative service delivery (ASD) policy that took effect in April 2002. Treasury Board Secretariat officials told us that this policy applies to departmental ASD initiatives including foundations that are classified as shared governance corporations. Our sample includes six such foundations. Since the ASD policy came into effect, a new foundation also classified as a shared governance corporation was funded by the federal government. However, Secretariat officials informed us that the ASD policy did not apply in this instance because the new foundation was incorporated under the *Canada Corporations Act*, by parties outside the government. The application of the ASD policy with respect to foundations is not clear.

4.64 The ASD policy requires departments to prepare a case analysis as part of the approval process for new initiatives, with some exceptions. The analysis must address key policy considerations that reflect the public interest, including questions on governance, results to be achieved, service delivery, and values and ethics. However, some sponsoring departments informed us that they had first learned of the amount to be paid to foundations only when federal budgets were announced. In our view, case analyses or their equivalent are needed to ensure that the amount and timing of the payments are fully justified prior to funding announcements.

4.65 The ASD policy does not require case analyses for additional payments to existing foundations. However, Treasury Board Secretariat officials told us that departments are required to make their case in submissions to the Treasury Board for funding to foundations, including increases to existing ones following public announcements.

4.66 **Recommendation.** The Treasury Board Secretariat should clarify the application of the policy on alternative service delivery with respect to foundations and include a requirement for case analyses (or equivalent) prior to announcements of funding for new or existing foundations.

Government's response. The Policy on Alternative Service Delivery, effective 1 April 2002, applies to the government organizations named in Schedules I, I.1, and II of the *Financial Administration Act* when seeking to create new organizations structured as shared governance corporations. Several foundations meet the policy criteria; however, they were created prior to the policy coming into force. The policy cannot be applied retroactively; however, should these foundations be considered for restructuring in the future, the policy would then apply in that instance. The policy does not apply to third parties that create foundations.

It is important to distinguish between organizational form decisions and funding decisions. The purpose of the Policy on Alternative Service Delivery is to ensure that the choice of organizational form is in the public interest. Funding decisions do not fall under the Policy. However, many of the same principles found in the Policy apply to the funding of organizations, such as foundations, through transfer payments. For example, the decision to fund the one foundation privately created after the Policy on Alternative Service Delivery came into effect in 2002 was made after a case analysis was completed. The transfer payment funding proposal was then approved by the Treasury Board. The Policy on Transfer Payments is currently under review, and the requirement for a case analysis prior to funding will be considered for inclusion.

4.67 **Federal appointees.** As noted earlier, six foundations in our sample are shared governance corporations—corporate entities to whose governing bodies Canada has a right to appoint or nominate one or more members. The President of the Treasury Board's 2003 *Annual Report to Parliament, Crown Corporations, and Other Corporate Interests of Canada* shows the proportion of board members of shared governance corporations who are federally appointed. This information aims to provide an indicator of the degree of federal influence over the entity where control cannot be expressed in terms of share ownership. The government's response to the 14th Report of the Standing Committee on Public Accounts stated that federal appointees do not represent the department or the government and, like other board directors, they have a fiduciary responsibility to act in the best interests of the foundations.

4.68 Treasury Board Secretariat and Privy Council Office officials also informed us that guidance to federal appointees on their responsibilities as board directors should come from the foundations themselves. In our view, the government's position does not deal clearly with the manner in which government officials, appointed to the foundation boards, are expected to exercise federal influence.

Evaluation concerns remain

4.69 The Budget Plan commitments did not address our recommendation for a government-wide evaluation of the use of new governance arrangements, including foundations, and for the results of this evaluation to be tabled in Parliament. Reliable information from a government-wide evaluation would allow Parliament to assess whether foundations have proved to be an effective policy instrument.

Accountability framework

4.70 In our 2002 audit, we suggested a framework for new governance arrangements, including foundations. In this follow-up audit, we assessed the elements of this framework that are essential to accountability to Parliament (Appendix C). We found that these elements are still relevant and added the following as a result of our audit:

- the government's commitment to situate foundations' significant expected results within sponsoring departments' reports on plans and priorities and significant results achieved within departmental performance reports; and
- that evaluations commissioned by foundations apply recognized evaluation standards.

Conclusion

4.71 We found a number of improvements in the accountability of foundations to Parliament. However, the government's overall progress is unsatisfactory because important gaps remain in the areas of the external audit regime and ministerial oversight:

- The government has no commitment to provide for performance audits reported to Parliament. Thus, Parliament does not have adequate information and assurance on the use of more than $9 billion in public funds already transferred to foundations.
- Inadequate provision has been made for the government to adjust foundations' mandates or policy directions where circumstances have changed considerably.

4.72 We also found that

- the independence of foundations raises questions about the government's ability to ensure adequate accountability to Parliament, in particular through reporting by sponsoring departments and by foundations;
- with a few exceptions, commitments to report on results are not being met; and
- departments need leadership from the Treasury Board Secretariat—in particular, clarification of the policy framework for sponsoring departments.

4.73 The government has made commitments to improve a number of elements of the accountability framework, particularly reporting. To meet these commitments, the sponsoring departments have introduced provisions in funding agreements and have implemented a number of them.

4.74 We assessed our accountability framework for foundations and concluded that it is still relevant, with the addition of the federal government's commitments on reporting and our new element on the need for evaluation standards.

Government's overall response. The government is pleased that the Auditor General has recognized that progress has been made in improving the accountability framework relating to foundations. However, it does not share her conclusion that overall progress is unsatisfactory.

In order to evaluate the progress made, it will be important to consider the principles, as outlined in Budget Plan 2003, which the government applies when using a foundation to deliver public policy:

- Foundations should focus on a specific area of opportunity, in which policy direction is provided generally through legislation and/or a funding agreement.
- Foundations should harness the insight and decision-making ability of independent boards of directors with direct experience in and knowledge about the issues at stake.
- Decisions by foundations should be made using expert peer review.
- Foundations should be provided with guaranteed funding that goes beyond the annual parliamentary appropriations to give the foundations the financial stability needed for the comprehensive medium- and long-term planning that is essential in their specific area of opportunity.
- Foundations should have the opportunity and hence the ability to lever additional funds from other levels of government and the private sector.

In direct response to previous recommendations by both the Auditor General and the Standing Committee on Public Accounts, the government undertook in Budget Plan 2003 to strengthen the accountability regime relating to transfer payments to foundations.

Funding agreements were renegotiated and in some cases legislation was amended, to put in place measures that strengthened accountability while at the same time respecting the independence of these not-for-profit organizations.

To improve transparency and accountability, reporting to ministers, Parliament, and the public was strengthened. Ministers table in Parliament the annual reports containing audited financial statements of foundations, representing 80 percent of the transfers noted by the Auditor General.

Foundations regularly report their plans and results to departments who are required to incorporate significant items in their reports on plans and priorities and departmental performance reports to Parliament. Some of the measures introduced, such as the requirement to situate the plans and results of foundations within those of departments, actually exceed the expectations of the Auditor General.

Regarding the audit and evaluation regime, a number of steps were taken to supplement the previous requirement for independent professionally accredited external auditors and periodic evaluations. New requirements include compliance audits to ensure adherence to the terms and conditions of the funding agreements and departmental evaluations to permit horizontal assessments of different programs. As noted in Budget Plan 2003, the Auditor General can undertake the compliance audits at the discretion of ministers. The foundations' external auditors are required under professional auditing standards of the Canadian Institute of Chartered Accountants to assess the adequacy of internal controls. Foundations are also required to report on their performance in their annual reports, which is subject to review by their external auditors, who could also conduct performance audits.

With respect to ministerial oversight, changes have been made that strengthen the default provisions of the funding agreements to enable corrective action if things go wrong. In addition, funding provisions and legislative changes have been made to permit the recovery of unspent funds in the event a foundation is wound down. It has been possible to effect other adjustments through the renegotiation of funding agreements and changes to legislation. These adjustments respect the independence of these organizations and do not involve the unilateral redirection of funds by the government. As with all transfer payments to other governments and not-for-profit organizations, funds are transferred based on agreements between arm's length organizations. It would not be appropriate for the federal government to unilaterally redirect these funds or the assets purchased with them. The government believes that the level of parliamentary and ministerial oversight is appropriate given the independence of these organizations.

Finally, with respect to the accounting for transfers to foundations, the government continues to hold the view that its accounting treatment respects the objective accounting standards of the Canadian Institute of Chartered Accountants. These are accounted for in a manner consistent with the treatment of other transfers such as those to provinces, which the Auditor General has accepted. Such transfers provide long-term stable funding that is needed to attract financial resources and expertise into areas of strategic importance. Decisions relating to such transfers take place once the government has the financial flexibility to fund these priorities. Such decisions and announcements have been made throughout the year and not only at year-end.

In conclusion, the government has taken a number of steps to strengthen overall accountability and transparency relating to transfer payments to foundations. It is willing to explore with the Auditor General those recommendations that will further improve this framework, while at the same time respecting the independence of these organizations and legitimate policy objectives sought.

About the Follow-Up

Objectives

Our audit objectives focussed on developments and potential changes to the governing framework for new governance arrangements as it applies to sponsoring departments and foundations. Specifically, we sought

- to assess the extent to which the government, central agencies, and sponsoring departments have acted to improve the accountability of government-sponsored foundations to Parliament; and
- to reassess, in light of the findings of this audit, the elements of the governing framework presented in our 2002 audit that we considered essential for effective accountability to Parliament.

Scope and approach

This follow-up audit looked at developments in accountability since January 2002 by examining three highly interrelated areas—that is, the elements of the governing framework identified in our 2002 chapter that we considered essential for accountability to Parliament:

- **Reporting to Parliament and the public**. This includes reporting by sponsoring departments as part of the Estimates process and reporting by foundations in corporate plans, annual reports (with evaluation results), and audited financial statements.
- **Ministerial oversight**. This includes strategic monitoring mechanisms (for example, compliance audit of funding agreements by sponsoring departments) and procedures to allow the government to make adjustments and deal with mandate and performance issues.
- **External audit and evaluation.** This includes broad-scope audit and a combination of credible and independent audits and evaluations.

Sample. In addition to some of the sponsoring departments and foundations we examined in 2002, we included the Aboriginal Healing Foundation as an early example of a foundation; the Pierre Elliott Trudeau Foundation to which the government first applied many of its accountability improvements; and, for comparative purposes, the Canadian Institute for Advanced Research, which has received ongoing funding as well as up-front funding. Indian Residential Schools Resolution Canada is the sponsoring department for the first foundation and Industry Canada for the other two.

Criteria

We expected that

- sponsoring departments have taken action to ensure that adequate provision for reporting of foundations' financial and non-financial performance and results to Parliament and the public is included in the enabling legislation, funding agreements, ministerial direction or other mechanisms, and that such reporting is taking place, or planned;
- sponsoring departments have taken action to ensure that adequate provision for external audit, program evaluation, and review in foundations is included in the enabling legislation, funding agreements, ministerial direction, or other mechanisms, and that such audit, evaluation, and review is taking place, or planned;
- sponsoring departments have taken action to ensure that adequate provision for ministerial oversight of foundations is included in the enabling legislation, funding agreements, ministerial direction, or other mechanisms, so that adjustments can be made in foundations' delivery of public policies, or that such a mechanism is planned; and
- the Privy Council Office, Finance Canada, and the Treasury Board Secretariat have taken a leadership role in providing guidance and developing best practices for use by sponsoring departments, and that sponsoring departments are following Treasury Board policies in setting up and monitoring foundations, and in ensuring accountability to the government and Parliament.

Audit team

Assistant Auditor General: Ronnie Campbell
Principal: Tom Wileman
Director: Nola Juraitis

Sophie Chen
Alex Smith
Frances Smith
Graeme Williamson

For information, please contact Communications at (613) 995-3708 or 1-888-761-5953 (toll-free).

Appendix A Budget Plan 2003—Commitments on the accountability of foundations

In 1997 the Government introduced a new approach to meeting the needs of Canadians—foundations. Foundations use up-front endowment funding and independent arm's-length boards of directors made up of experienced and knowledgeable individuals. Their arm's-length nature, financial stability and focused expertise allow them to address specific challenges in a highly effective, non-partisan manner. As a result, foundations have become important tools for implementing policy, in particular in areas such as research and development and education, where expert knowledge, third-party partnerships and stable long-term funding are especially important.

To clarify the circumstances under which foundations are used by the Government, this budget sets out principles which the Government would consider in using a foundation to deliver public policy:

- Foundations should focus on a specific area of opportunity, in which policy direction is provided generally through legislation and/or a funding agreement.
- Foundations should harness the insight and decision-making ability of independent boards of directors with direct experience in and knowledge about the issues at stake.
- Decisions by foundations should be made using expert peer review.
- Foundations should be provided with guaranteed funding that goes beyond the annual parliamentary appropriations to give the foundations the financial stability needed for the comprehensive medium- and long-term planning that is essential in their specific area of opportunity.
- Foundations should have the opportunity and hence the ability to lever additional funds from other levels of government and the private sector.

These policy principles are consistent with the Treasury Board's new Policy on Alternative Service Delivery, which came into effect on April 1, 2002.

A key ingredient of the success of foundations is their independence. However, this has led to some concern as to their transparency and accountability. Current funding agreements with foundations specify their mandates and the conditions under which they operate. Further, directors are fully responsible for the actions of foundations, and all foundations are subject to annual independent audits of their financial statements.

As part of its ongoing effort to improve transparency and accountability, the Government will make a number of changes to improve the accountability of foundations to Canadians and parliamentarians.

Parliamentary Approval: The Government is taking steps to ensure that the establishment and funding of foundations is adequately reviewed by Parliament.

- The Government is committed to parliamentary approval of purpose and funding through direct legislation for those foundations that are significant either from a policy or financial perspective. In all cases Parliament will need to approve funding for foundations. As noted above, the Government's use of foundations will respect the requirements of the Treasury Board's Policy on Alternative Service Delivery.

Public Reporting: To improve the transparency and therefore the accountability of foundations to the public, the Government will take the following steps:

- Foundations will be required to provide corporate plans annually to the Minister responsible for administering the funding agreement over the duration of the agreement. Such corporate plans will include planned expenditures, objectives and performance expectations relating to the federal funding. Summaries of these plans will be made public by the responsible Minister and provided to Parliament.
- In addition, the departmental Reports on Plans and Priorities, which are tabled in Parliament, will incorporate the significant expected results to be achieved by the relevant foundations and situate these within the Department's overall plans and priorities. As well, the Department responsible for administering the funding agreement will report on the significant results achieved by the foundation(s) in its Departmental Performance Report for the duration of the funding agreement and situate these within the Department's overall results achieved.

- The Annual Report for each foundation, including relevant performance reporting, audited financial statements and evaluation results, will be presented to the Minister responsible for the funding agreement and made public. The Annual Reports of foundations created explicitly through legislation will be tabled in Parliament by the responsible Minister.
- All foundations' Annual Reports will contain performance information as well as audited financial statements prepared in accordance with Generally Accepted Accounting Principles. As foundations are independent, not-for-profit organizations that have their own governance structures and members, it is the members, as "shareholders" of the foundation, who appoint their external auditor and to whom the external auditor reports.

Compliance With Funding Agreements: The accountability of foundations will be further enhanced through the following measures:

- Foundations will be required to conduct independent evaluations, present these to the Minister responsible and make them public. Departments will incorporate any significant findings in their annual Departmental Performance Reports, which are tabled annually in Parliament.
- Funding agreements reached with foundations arising from the 2001 budget contain provisions for independent audits of compliance with funding agreements and for program evaluations. There will also be provisions for intervention in the event the responsible Minister feels there have been significant deviations from the terms of the funding agreement. The provisions will provide for dispute resolution mechanisms.
- Further, in all new funding agreements provisions will be put in place so that the responsible Minister may, at his/her discretion, recover unspent funds in the event of winding up.

The above is on a going-forward basis. The Government will also consult with existing foundations to explore making changes to their agreements with the Government to incorporate these new requirements.

The adoption of these requirements addresses many of the issues about accountability of foundations that were raised in the April 2002 Report of the Auditor General of Canada.

Appendix B Description of foundations in the audit

Foundations and sponsoring departments	Description
Eight foundations followed up from the April 2002 audit	
Canada Foundation for Innovation Established in 1997 Industry Canada	An independent, non-profit corporation created under the *Budget Implementation Act,* 1997 for the purpose of making grants to universities, colleges, hospitals, and other not-for-profit institutions to increase the capability of carrying out high-quality research in Canada.
Canada Health Infoway Inc. Established in 2001 Health Canada	A non-profit corporation whose purpose, through collaboration with the public and private sector, is to accelerate the development and adoption of modern systems of information and communication technology in the health sector while ensuring common standards and interoperability.
Canadian Health Services Research Foundation Established in 1997 Health Canada	The foundation's mission is to support evidence-based decision making in the organization, management, and delivery of health services through funding research, building capacity and transferring knowledge.
Canada Millennium Scholarship Foundation Established in 1998 Human Resources and Skills Development Canada	An independent body created through the *Budget Implementation Act,* 1998 to manage a $2.5 billion federal endowment for 10 years starting in 2000. It grants scholarships to students.
Genome Canada Established in 2000 Industry Canada	Genome Canada invests and manages large-scale projects in key selected areas such as agriculture, environment, fisheries, forestry, health, and new technology development. Genome Canada also supports research projects aimed at studying and analyzing the ethical, environmental, economic, legal, and social issues related to genomics research.
The Green Municipal Enabling Fund (GMEF) and Green Municipal Investment Fund (GMIF) Established in 2000 Natural Resources Canada and Environment Canada	The Federation of Canadian Municipalities administers these funds. The GMEF provides cost-shared grants for feasibility studies on projects designed to improve air, water, and soil quality. The GMIF provides interest-bearing loans, loan guarantees, and grants that enable recipients to carry out energy and environmental projects in municipal operations.
Sustainable Development Technology Canada Established in 2001 as the Foundation for Sustainable Development Technology in Canada Natural Resources Canada and Environment Canada	An arm's-length foundation, established by federal legislation to provide funding to consortia from the private sector, universities, research organizations, and not-for-profit corporations for technology development and demonstration, namely for climate change and air quality solutions. The foundation will complement sustainable development activities of other government departments.

Foundations and sponsoring departments	Description
Three additional foundations referred to in this audit	
Aboriginal Healing Foundation Established in 1998 Indian and Northern Affairs Canada*	The foundation is funded by the Government of Canada to support the projects and programs that address the healing needs of Aboriginal people affected by the legacy of abuse in residential schools.
Canadian Institute for Advanced Research Established in 1982 Industry Canada	A corporation that provides researchers with the means to meet, interact, and collaborate with peers from across Canada and around the world to respond to the scientific and social challenges of tomorrow.
The Pierre Elliott Trudeau Foundation Established in 2001 Industry Canada	Created as a not-for-profit corporation, the foundation seeks to commemorate the late Prime Minister Pierre Elliott Trudeau by funding advanced study and research in Canada in the humanities and human sciences. The foundation also grants fellowships to mid-career researchers and mentorships to seasoned professionals who work in the field of public policy.

* The sponsoring department is now Indian Residential Schools Resolution Canada

Appendix C Our accountability framework for foundations

Changes to the governing framework since our April 2002 Report are in italics.

Element	Description
To ensure accountability to Parliament	
Reporting to Parliament and the public	
Corporate plans	Plans including objectives, strategies to be pursued, and expected accomplishments should be made public and tabled in Parliament. Provision for an initial corporate plan and an update at least every three years would be reasonable. *The significant results expected from the relevant foundation should be situated within the department's overall plans and priorities in its Report on Plans and Priorities.*
Annual performance reporting, including audited financial statements	Timely, appropriate, and credible information on the extent to which the *foundation* has accomplished its federal policy objectives, and at what cost, should be reported to the ministers responsible, Parliament, and the public in an annual report or a departmental performance report, as appropriate. *The significant results achieved by the foundation should be situated within the department's overall results, reported in its Departmental Performance Report.*
Evaluation results	The findings from independent evaluations should be tabled in Parliament.
External audit *and evaluation* regime	
Performance audit reported to Parliament	In *foundations*, the external auditor should carry out attest, compliance, and *performance* audits. In all cases, audits would be reported to the board of directors, the sponsoring minister, and Parliament.
Evaluation standards	*Sponsoring departments should ensure that evaluations commissioned by foundations pursuant to legislation or funding agreements apply recognized evaluation standards.*
Ministerial oversight	
Strategic monitoring mechanisms, including compliance audit	Strategic monitoring by the sponsoring department should be in place to ensure that timely information is available on stewardship, the results achieved, and overall compliance with terms and conditions.
Procedures to deal with non-performance	Reasonable provisions should be in place to deal with non-performance of the *foundation*, and termination, if needed. In *foundations*, the government should be able to intervene in the exceptional case where the public purpose of the arrangement is clearly not being met or circumstances have changed considerably since the creation of the arrangement. In the event of termination, or windup for any reason, the federal government should be able to recover any remaining federal moneys.

Appendix D Progress on recommendations

Recommendations of our April 2002 Report, Chapter 1	Recommendations of the 14th Report of the Standing Committee on Public Accounts	Recommendation accepted or rejected by the government	Progress made by the government
1.37 If the federal government decides to create delegated arrangements that involve significant changes in policy or significant commitment of public funds or assets, it should do so through direct legislation.		Accepted regarding direct legislation	○
The Privy Council Office should ensure that this legislation meets the essential requirements for good governance and accountability to Parliament.		No clear response from the Privy Council Office	
1.49 To ensure adequate reporting to Parliament on delegated arrangements, sponsoring ministers should table the following in a timely manner: • multi-year plans [now called corporate plans]; • the findings of evaluations; and • annual reports on what has been accomplished that include audited financial statements. These documents should be referenced in the sponsoring departments' Estimates documents.	That the government seek every opportunity to persuade existing foundations to incorporate amendments to their accountability and reporting framework that will strengthen the reporting to Parliament and to the public, including the reporting of performance expectations, performance results achieved, and disclosure of audited financial statements and evaluation reports.	Accepted	●
	That the government seek amendments to the funding agreements of existing foundations, either created through legislation, or receiving significant funding (at least $500 million) from the federal government, that would require them to table in Parliament separate annual reports, reports on plans and priorities, and departmental performance reports.	Rejected	

● Satisfactory ○ Unsatisfactory

Recommendations of our April 2002 Report, Chapter 1	Recommendations of the 14th Report of the Standing Committee on Public Accounts	Recommendation accepted or rejected by the government	Progress made by the government
1.54 The federal government should ensure that adequate mechanisms are in place for broad-scope audit of all delegated arrangements. The Auditor General should be appointed as the external auditor of foundations, with a few exceptions.	That for those foundations either created through legislation, or receiving significant federal funding (at least $500 million), the federal government seek amendments to the funding agreements that provide for periodic program evaluation, value-for-money audits, and independent assessment of the fairness and reliability of the performance information, the results of which are to be reported through ministers to Parliament. That for those foundations either created through legislation, or receiving significant federal funding (at least $500 million), the federal government appoint the Auditor General of Canada as external auditor of these foundations.	Rejected	
1.62 The federal government should ensure that an adjustment mechanism is in place that allows sponsoring ministers to intervene in a delegated arrangement in the exceptional case where the arrangement is clearly not meeting its public purpose or where circumstances have changed considerably since its creation.	That the government seek every opportunity to persuade all existing foundations to incorporate into their existing accountability and governance framework, new provisions that will strengthen the ministerial oversight function, including strategic monitoring, redress procedures in case of non-performance, clearly defined provisions enabling departmental audit and evaluation of foundation activities, and mechanisms to recover unspent federal funds in case of the winding up or termination of the foundations.	Accepted in part for extreme situations	○
1.63 The federal government should ensure that provision is made to allow sponsoring departments to undertake compliance audits of delegated arrangements.		Accepted	●
1.64 In the event of the winding up or termination of any delegated arrangement, the federal government should recover unspent federal funds.		Accepted	●
1.69 The Privy Council Office should ensure that departments fully define the roles and responsibilities of federal appointees to boards of delegated arrangements. The federal government should resolve the issue of the potential conflict of duties.		Rejected	

● Satisfactory ○ Unsatisfactory

Recommendations of our April 2002 Report, Chapter 1	Recommendations of the 14th Report of the Standing Committee on Public Accounts	Recommendation accepted or rejected by the government	Progress made by the government
1.115 The Treasury Board Secretariat should ensure that its database on alternative service delivery collects and makes available adequate information on the types and number of new governance arrangements created by federal departments. The database should also provide government managers with information on lessons learned and good practices by arrangements.		Accepted	●
1.116 The Treasury Board Secretariat should review exemptions to the Treasury Board policy against making payments in advance of need. The findings of this review should be reported to Parliament.		Rejected	
1.117 The Treasury Board Secretariat should develop an evaluation framework and undertake, after a suitable interval, a government-wide evaluation of the use of new governance arrangements as instruments of public policy. The results of this evaluation should be reported to Parliament.		Rejected	

● Satisfactory ○ Unsatisfactory

Chapter

5

Canadian International Development Agency

Financial Compliance Audits and Managing Contracts and Contributions

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Canadian International Development Agency

Financial Compliance Audits and Managing Contracts and Contributions

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Main Points

5.1 Overall, CIDA has made satisfactory progress on our recommendations made in 1999 and 2000. Progress has been made in the key areas of competition of agreements, deposits to counterpart funds, the monitoring of project risks and sustainability of benefits, and the documentation of decisions related to its audits of contribution agreements.

5.2 We noted improvement in CIDA's use of non-competitive contributions. In the files we examined, the use of unjustified sole-sourcing of contributions had decreased significantly. In addition, the total value of sole-source contracts awarded had decreased significantly since our previous audit. For the counterpart funds we audited, we found only minor cases of non-compliance with CIDA policy.

5.3 In 1999 we observed that CIDA rarely documented the rationale for its decisions not to recover amounts found to be in error by its financial compliance audits of contribution and contract agreements. CIDA has improved its documentation of this type of decision, but in the files we examined, half of such decisions had still not been justified or were not properly documented.

5.4 During the course of our follow-up, we became aware of weaknesses in three additional but related areas: in-kind contributions, authorities for releasing amounts due from executing agents, and the management of grants. We found that CIDA officers rarely analyze the value of in-kind contributions that recipients of its funding claim they will make or verify that there is no provision for profit by the recipient—as is required by CIDA policy. In many cases, CIDA officers decided to release the Canadian executing agencies from the obligation to repay money received for expenditures that were not covered under the terms of their agreements. Since our 2000 audit, CIDA has sharply increased the use of grants rather than contributions to fund aid projects. We are concerned that, without having assessed the probable impact on expected development results, by using grants CIDA may be sacrificing a degree of control and oversight over how recipients spend CIDA funding. CIDA also disbursed grant funds in advance of need without a proper explanation on file.

Background and other observations

5.5 The primary objective of this follow-up was to assess what CIDA had done to address the issues and recommendations that were raised in two of our previous reports, the November 1999 Report, Chapter 28, Canadian

International Development Agency—Financial Controls over Projects; and the October 2000 Report, Canadian International Development Agency—Managing Contracts and Contribution Agreements. The follow-up focussed on four main areas: the process for awarding contracts and contribution agreements related to aid projects, how CIDA has responded to the results of financial compliance audits concerning non-compliance with agreement terms, controls over payments into counterpart funds, and project implementation processes for managing project risks and outcomes. We did not follow up on several other issues raised in those chapters including: general financial controls, project design, or Partnership Branch agreements. We also audited three additional issues related to the previous observations: in-kind contributions by recipients, the use of grant agreements, and the authorities related to non-collection of amounts identified for recovery by financial compliance audits.

5.6 CIDA is responsible for managing about $2.6 billion of Canada's international assistance. The Agency's program expenditures consist of transfer payments made to its executing agents and partners under the terms of the formal funding agreements. These include contracts, contribution agreements, and grant agreements. Government Contracts Regulations and the Treasury Board contracting policy govern the awarding of aid contracts. CIDA's contributions and grants are governed by the Treasury Board approved Terms and Conditions for International Development Assistance and the associated framework policy.

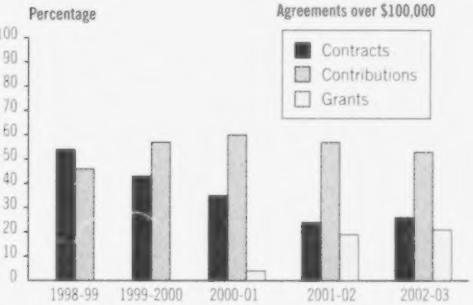
The Canadian International Development Agency has responded. CIDA has indicated the actions it intends to take to address the recommendations. Its detailed response follows each recommendation throughout the chapter.

Introduction

5.7 This audit is a follow-up of key issues raised in two previous audits that our Office carried out. In November 1999, we reviewed the financial controls that CIDA had put in place for managing its development projects. In October 2000 we examined how CIDA managed its contracts, contribution agreements, and other types of agreements for goods and services, including the selection of Canadian executing agencies to deliver projects. The Public Accounts Committee held one hearing on the 2000 Chapter and issued a report that supported our observations and recommendations.

5.8 The Canadian International Development Agency is responsible for managing about $2.6 billion of Canada's international development assistance. CIDA's program expenditures consist of contracts, contributions, grants, and other transfer payments. CIDA makes these payments to institutions in Canada and developing countries, provincial governments and their organizations and agencies, and to Canadian private-sector firms. Payments relate to funding specific development projects, programs, and activities. CIDA's relationship with its partners is governed by the formal agreements they sign with these organizations. Exhibit 5.1 shows the distribution of contracts, contributions, and grant agreements over $100,000 by dollar value in the Geographic Branches, excluding food aid. The Geographic Branches carry out geographic programs, also referred to as bilateral or country-to-country programs; they also manage contracting and other types of agreements for goods and services, including the selection of Canadian executing agencies to deliver projects.

Exhibit 5.1 Distribution of contract, contribution, and grant agreements over $100,000 in CIDA's Geographic Branches



Source: CIDA (unaudited)

5.9 CIDA is accountable for selecting its partners and for developing and managing its agreements with them. The awarding of contracts for both aid and corporate services is subject to Government Contracts Regulations and Treasury Board contracting policy. CIDA's grant and contribution agreements are not subject to the Government Contracts Regulations and are governed by the Terms and Conditions for International Development Assistance approved by Treasury Board effective 22 March 2001 and the associated Framework Policy for International Development Assistance.

Focus of the follow-up

5.10 The primary objective of this follow-up was to assess what CIDA had done to address the issues and recommendations that were raised in our two previous reports:

- We examined the contractor-selection process for contracts, contribution agreements, and grants to ensure that they respected Treasury Board directives, the Terms and Conditions for International Development Assistance, and CIDA's internal policies. Our focus was on ensuring that, when required, CIDA carried out a proper competitive-selection process.
- We assessed how CIDA had dealt with the results of financial compliance audits of contracts and contributions.
- We reviewed a set of issues around controls for payments to counterpart funds that we raised in 2000 (and previously in 1998).
- We reviewed the progress that CIDA has made regarding various project implementation issues.

5.11 Further details about the follow-up can be found in **About the Follow-Up** at the end of the chapter.

Observations and Recommendations

Contractor selection

Competitive and non-competitive contribution agreements

5.12 An open, competitive bidding process provides the best guarantee that qualified vendors will have a fair chance to do business with the government and that the government will receive good value for its contracting dollars. The Government Contracts Regulations affirm that competition is the norm, and that departments are to solicit bids before entering into a contract. It is also standard government practice to award contributions without competition to support non-governmental organization projects or activities.

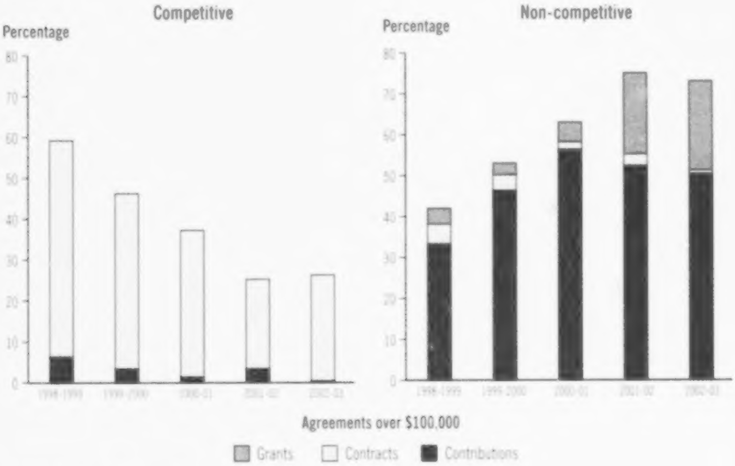
Contributions—Conditional transfers in which specific terms and conditions must be met or carried out by the recipients before costs are reimbursed.

Grants—Unconditional transfer payments, where eligibility criteria and applications received in advance of payment is sufficient assurance that the payment objectives will be met.

5.13 Exhibit 5.2 shows the distribution of competitive and non-competitive agreements over $100,000 signed in the Geographic Branches from 1998–99 to 2002–03. These include goods and services contracts, contributions, and grants. CIDA's Manager's Guide to Contribution Agreements explains the main features of both contracts and contribution agreements in CIDA (see Exhibit 5.3); it does not cover grants.

5.14 In our 2000 audit, we said that over the years CIDA had subscribed to the principles of competition for contracts, but not for contribution agreements. We noted that CIDA's terms and conditions for contribution agreements that Treasury Board had approved in 1996 were very general. The terms and conditions did not provide any direction on the use of either

Exhibit 5.2 Competitive and non-competitive agreements over $100,000 in CIDA's Geographic Branches



Source: CIDA (unaudited)

the competitive or non-competitive approaches to entering into contribution agreements. We found that the lack of clear direction had resulted in instances in which CIDA staff used a non-competitive process for contributions relating to solicited proposals when, according to the then-current policy, they should have followed a competitive process.

5.15 In June 2000, Treasury Board issued a new policy on transfer payments (grants and contributions). The objective of the policy is "to ensure sound management of, control over and accountability for transfer payments." The policy calls for departments and agencies to submit for approval new terms and conditions for their transfer payment programs before April 2005.

5.16 In our 2000 audit, we recommended that CIDA should include a framework that clarifies how and when it will use contribution agreements when submitting its next set of terms and conditions to the Treasury Board for approval in 2001. In response, CIDA said that it would introduce a more structured framework to provide better guidance to CIDA staff on using contribution agreements, especially for solicited proposals.

CIDA updated its policies on contribution agreements, but gaps exist

5.17 CIDA received Treasury Board approval for its renewed Terms and Conditions for International Development Assistance in March 2001. They included a Framework Policy for International Development Assistance. However, these documents did not include a clearer framework for using contribution agreements. Unlike the framework that governs contracts, CIDA's Terms and Conditions and the Framework Policy for International Development Assistance still do not clarify the circumstances under which a competitive or a non-competitive process can be used for contribution agreements involving non-responsive/solicited proposals.

Exhibit 5.3 Main features of contract and contribution agreements in CIDA

	Contract	Contribution
Purpose	To engage the services of a supplier, purchase goods, and/or lease real property	To provide funding to an independent party's development project
Legal status	Legally binding	Legally binding
Subject to	• Trade agreements • Government Contracts Regulations • Contracting authorities delegated by Treasury Board • CIDA contracting policies	• Treasury Board Policy on Transfer Payments • CIDA's Terms and Conditions for International Development Assistance (approved by Treasury Board) • CIDA's Framework Policy for International Development Assistance Note: While contribution agreements are not subject to the Government Contracts Regulations and Treasury Board contracting policy, CIDA project managers are expected to reflect the spirit of the Government Contracts Regulations when using contribution agreements.
Profit	Profit is allowed for the proponent and subcontractors	No profit is allowed for the proponent
Cost-sharing	Not applicable	Taken into account when assessing proposals
Agreement mechanism	**Must be open to competition**, with four types of exceptions allowed for sole-sourcing under the Government Contracts Regulations. The exceptions, when used inappropriately, are the focus of our audit observations.	**Responsive** (idea proposed to CIDA): No competition is required. **Non-responsive/solicited** (idea originates in CIDA): CIDA requires competition as the norm, with undefined exceptions allowed. These exceptions are the focus of our audit observations, in cases where they would not meet the four exceptions under the Government Contracts Regulations if they were contracts.

Source: Adapted from CIDA's Manager's Guide to Contribution Agreements

5.18 The Government Contracts Regulations and the Treasury Board contracting policy do not apply to contributions. However, CIDA's Manager's Guide to Contribution Agreements indicates that "project managers are expected to reflect the spirit of the Government Contracts Regulations when using contribution agreements."

5.19 CIDA's Contracting Guide for Managers, which was issued in 2000, included a chapter on using contributions. CIDA's Manager's Guide to Contribution Agreements, which was published in 2002, helps staff to better understand how they can use contribution agreements to advance the Agency's programming priorities. Both the Manager's Guide to Contribution Agreements and the Contracting Guide for Managers try to clarify the circumstances under which the process for awarding contributions should be competitive or non-competitive. Both guides indicate that for responsive/

unsolicited proposals (that is, when an outside agency has developed the idea for a project), non-competitive contribution agreements may be used. For non-responsive/solicited proposals (those for which CIDA has originated the idea for a project), competitive contributions are appropriate. Both documents allow for exceptions.

5.20 For example, CIDA's Contracting Guide for Managers says that, "whenever practical," competition is the rule for solicited proposals for contributions. However, neither the Contracting Guide for Managers nor the Manager's Guide to Contribution Agreements clearly defines the circumstances under which exceptions are allowed. As a result, there is uncertainty about when a non-competitive contribution can be used in a situation where CIDA solicited the proposal. Although our sample showed much less use of sole-sourcing than in the sample in our 2000 audit, we still found instances where CIDA awarded contributions without competition for solicited proposals. This continuing uncertainty has led us to conclude that the problems we observed in our 2000 audit with the use of contribution agreements have not been conclusively resolved by CIDA policies.

5.21 We audited 19 contribution agreements out of a total of about 1,400 agreements that were over $100,000 in value, and that were awarded between January 2001 and August 2003. Nine files were coded as "responsive contribution agreements" (that is, arising from unsolicited proposals), and these contributions were awarded without competition, which was according to CIDA policy. Another ten files were coded as "traditional contribution agreements" (that is, those that were not open for competition). In our opinion, two of those agreements should have been open to competition because CIDA solicited them, and the files showed that there may have been other potentially qualified suppliers. Those two did not follow CIDA policy. Overall, these results were a considerable improvement over our findings in 2000 where 6 of 11 contributions we audited had not followed CIDA policy.

5.22 In 2000, we recommended that a separate group within CIDA should review all proposed non-competitive contracts and contribution agreements over $100,000 for compliance with authorities and CIDA policy. CIDA agreed to act on this recommendation. In our follow-up, we found that CIDA had decided that each branch would carry out its own reviews but did not make them mandatory. For the non-competitive contracts and contribution agreements that we audited, we saw no evidence on file of any such review.

CIDA managers do not consistently verify recipients' share of contributions

5.23 In contribution agreements, the recipient often provides its own contribution toward the project, which may be "in-kind" such as volunteer time or donated equipment. The nature and extent of the recipient's own contribution is an important element in CIDA's decision to award a contribution. CIDA's Manager's Guide to Contribution Agreements states that contribution agreements should clearly indicate the nature, dollar value, and terms and conditions attached to in-kind contributions. We expected that CIDA would have verified the nature of the in-kind contributions, and that they had, indeed, occurred. However, this was not the case. The Contribution Guide does not give guidance on how to verify the existence or value of in-kind contributions. We found that managers had usually noted the recipient's intention to provide in-kind contributions in the contribution agreements. However, these agreements had not always clearly indicated what the in-kind contributions were to be. Of the 19 files that we reviewed, 12 had in-kind contributions. For 11 of those, we found no indication on file that CIDA had analyzed the in-kind contributions that were to be part of the contribution agreement, to determine their true value.

5.24 The Contribution Guide also states that no profit may be associated with a contribution agreement. Only 3 of the 19 contribution agreements that we audited showed evidence that CIDA had considered the elements of the project costs to ensure that no profit factor had been included.

5.25 **Recommendation.** CIDA should clarify the specific circumstances under which it considers awarding an agreement on a sole-source basis for solicited contributions acceptable.

CIDA's response. CIDA agrees with this recommendation and will develop a clear definition and clarify the context for the use of solicited contributions. By 1 February 2005, the necessary changes will be incorporated into CIDA's Manager's Guide to Contribution Agreements and into the Agency's training courses on the management of contributions.

5.26 **Recommendation.** CIDA's Manager's Guide to Contribution Agreements should make clear the steps required to analyze the value of proposed in-kind recipient contributions and that there is no provision for profit. Guidance should also be provided on how to verify that the recipient has made its contribution as agreed.

CIDA's response. CIDA agrees with this recommendation. Accordingly, by 1 February 2005, the Agency will define acceptable in-kind contributions from its development partners, develop criteria for assessing their value, and formulate guidelines for verifying that development partners have made in-kind contributions identified in contribution agreements. The Agency will also develop measures to ensure that there is no provision for profit in its contribution agreements. These will be incorporated into the Agency's Manager's Guide to Contribution Agreements as well as into training courses on the management of contributions.

Contract agreements

Sole-sourcing and contract splitting

5.27 In our 2000 audit, we observed instances in which contracts did not comply with either the Treasury Board contracting policy or the Government Contracts Regulations. In 2002, CIDA's internal audit unit published a report on the use of contracts awarded on a sole-source basis. The report highlighted several problems with the manner in which CIDA had applied Treasury Board policy, and included a number of recommendations for improvement. A follow-up audit was carried out in the fall of 2003 to assess the progress that CIDA managers had made toward respecting the policy. That audit had not yet been completed at the time our field work ended.

5.28 In our follow-up, we found that considerable progress had been made in this area, as the dollar value of sole-source contracts awarded in CIDA has decreased significantly since our 2000 audit. We selected five, large, sole-source contracts awarded after 2000 to determine whether CIDA had followed Government Contracts Regulations and Treasury Board policy in awarding these contracts. We again found cases where the Agency had not complied with government policy in this area. In our view, three of the five contracts we examined should have been open to competition.

5.29 One contract showed evidence of contract splitting, although both the Treasury Board policy and Public Works and Government Services Canada guidelines forbid this practice. It was one of two similar contracts to Hydro Quebec International for $95,000 and $98,000 that were let sequentially and fell just under the approved dollar threshold of $100,000 for sole-source contracts. Another contract of $62,000 for government-on-line development had been let as an aid contract instead of an administrative contract. The permitted dollar-threshold for sole-sourcing administrative contracts is $25,000, while the threshold for aid contracts is $100,000. Therefore, it should have been awarded on a competitive basis.

5.30 **Recommendation.** CIDA should ensure that the Government Contracts Regulations and the Treasury Board policy regarding the sole-sourcing of contracts are respected in all cases.

CIDA's response. The Agency agrees with this recommendation. CIDA will remind its contract officers of the Treasury Board's rules and guidelines associated with sole-source contracting. CIDA will implement a contracting compliance and performance monitoring function, at the outset of fiscal year 2005–06, that will include monitoring the compliance of sole-source contracts with the Treasury Board rules and government regulations and with CIDA contracting templates. The results of such monitoring will be reported to the Agency's Audit and Evaluation Committee on a regular basis.

Implementation

"Off-ramps" for larger agreements have not been implemented

5.31 In 2000, we noted that to have a large project planned and approved, tendered, contracted, and operationally planned can take anywhere from one to four or five years. It involves considerable expense and effort on the part of both CIDA and the host country partner. Given this large investment in resources, it is difficult for CIDA to decide to cancel the agreement when the expected results from the project are not forthcoming. CIDA did not build into its management of project agreements any formal requirement or mechanism for "off-ramp" provisions (clauses that allow CIDA to make a decision to withdraw from a project). We recommended that CIDA build a provision for a formal review point into its larger service agreements at which time a decision could be made on whether the project should be continued, cancelled, or have the scope changed. CIDA agreed.

5.32 In this audit, we found that CIDA has not done this. In the 24 contracts and contribution agreements examined, with the exception of one case, there were no specific off-ramp provisions included, other than the standard clauses for ending an agreement.

CIDA is doing a better job of monitoring risks and ensuring sustainability

5.33 In our 2000 audit we observed that generally CIDA and its executing agencies had been slow or unable to take responsibility to react when critical assumptions failed to materialize, and problems ensued. During our field visits as part of this follow-up, we found that for the projects we visited, CIDA and the Canadian executing agents' staff were monitoring project risks and updating critical assumptions.

5.34 A sustainable project is one whose benefits last after aid funding stops. For CIDA, sustainability is one of eight key factors that the Agency uses to measure a project's success. In our 2000 audit, we noted that CIDA should be more consistent in making sure that its agreements with Canadian executing agencies contain built-in provisions to ensure sustainability.

5.35 In this follow-up, our sample included 17 agreements where specific clauses related to sustainability would have been relevant. Fifteen of those agreements did contain clauses indicating how the Canadian executing agency would support or help ensure that the project would yield sustainable benefits. This represents a substantial improvement over what we found in our previous audit. We also found during our field visits that for the relevant cases, CIDA and Canadian executing agency staff were generally monitoring project activities designed to ensure sustainability of the project benefits.

CIDA grants

5.36 Grants and contributions are two of CIDA's key funding mechanisms. Exhibit 5.4 highlights certain key aspects of these two funding mechanisms.

Exhibit 5.4 Important differences between grants and contributions

CIDA uses grants and contributions to transfer funds to organizations involved in aid projects. These mechanisms differ in several key respects.

Contributions differ from grants in the management requirements that general government policy imposes on departments and on the recipients. An individual or organization that meets the eligibility criteria for a grant can usually receive the payment without having to meet any further conditions. In contrast, contributions are subject to performance conditions that are specified in a contribution agreement. The recipient must show that it continues to meet the performance conditions over the life of the agreement in order to be reimbursed for specific costs. The government can audit the recipient's use of a contribution, whereas audits are not required for grants.

For contributions, interest earned on CIDA payments must be used for the purpose of the program or project; unexpended balances must be repaid; and typically, there is a 10 percent holdback provision. Grants are unconditional transfer payments, and these provisions do not apply.

Source: CIDA and our reports

CIDA has sharply increased the use of grants in the past three years

5.37 When carrying out this audit, we noted that since the 1999–2000 fiscal year, the trend toward grants has increased markedly. The sharpest increase coincided with the new Terms and Conditions for International Development Assistance approved by the Treasury Board on 22 March 2001. This document allows CIDA to use grants according to "channels-of-delivery." This term, channel-of-delivery, refers to the type or purpose of aid, for example, bilateral aid; international humanitarian assistance; or assistance against hunger, malnutrition, and disease. The previous terms and conditions had placed restrictions on certain branches in the organization; for example, the former Bilateral Branches (now termed the Geographic Branches) had not been allowed to give grants. The new terms and conditions allow grants for the bilateral aid channel-of-delivery only on an exception basis.

5.38 The Terms and Conditions for International Development Assistance approved by the Treasury Board in 2001 delegate funding authority to CIDA. CIDA's Framework Policy for International Development Assistance is intended to further articulate a number of criteria for using grants or contributions, depending on CIDA's channels-of-delivery. The terms and conditions called for CIDA to continue publishing the specific criteria for individual channels-of-delivery in program documents. We found that since issuing the terms and conditions, CIDA has published no further specific criteria for using particular channels-of-delivery.

5.39 CIDA believes that grant support to the programs of multilateral institutions improves development results and reduces its own risks. In September 2002, CIDA issued a new policy statement on strengthening aid effectiveness, *Canada making a difference in the world*. It explains that the international community has identified principles of effective development and that there is a need to move toward more comprehensive and integrated approaches. In this context, CIDA intends to rely less on its traditional projects and more on a program approach. This involves co-ordinating with other donors and integrating its aid activities with the policies and plans of recipient governments.

5.40 Contributing to the programs of multilateral institutions provides CIDA's geographic programs with opportunities to benefit from those institutions' established delivery capacities, extensive field presence, technical expertise, and local credibility. CIDA also benefits from the due diligence efforts, technical and country expertise, and programming experiences of other donors. CIDA considers that the risk of non-performance associated with multilateral institutions is relatively low compared with traditional stand-alone projects using executing agencies working under a contract or contribution agreement.

5.41 Exhibit 5.5 shows the trend for the 1999–2000 to 2002–03 period. The use of grants by the Geographic Branches increased from approximately $6 million to $148 million, or from less than one percent to over eight percent of total Agency grants and contributions. The proportion of grants to the total amount of CIDA grants and contributions has increased from approximately 26 percent to 38 percent for the same time period.

5.42 We decided to select eight grants for more detailed audit. Our objective was to determine why CIDA was using grants as opposed to other funding

Exhibit 5.5 CIDA grants and contributions 1999–2000 to 2002–03 ($ millions)

	Grants				Contributions		Grants and contributions
	Geographic Branches (including former Bilateral Branches)		Agency total		Agency total		Agency total
Fiscal year	$	%	$	%	$	%	$
1999–2000	6.1	0.4%	374.4	25.7%	1,083.0	74.3%	1,457.4
2000–01	13.7	0.9%	498.2	31.8%	1,070.3	68.2%	1,568.5
2001–02	74.3	4.3%	625.2	36.6%	1,082.7	63.4%	1,707.9
2002–03	148.1	8.4%	660.3	37.6%	1,095.6	62.4%	1,755.9

Source: CIDA (unaudited data)

mechanisms. We also aimed to assess certain aspects of CIDA's administration of grants to the recipients.

5.43 The particular channel-of-delivery was not clearly indicated on file for five of the grants that we examined, and it was difficult for us to identify the channel based on the broad descriptions in the framework policy.

5.44 According to feedback from project officers and the descriptions of channels-of-delivery in the framework policy, three of the eight grants in our sample could belong to the bilateral-aid channel. The policy states that

> Bilateral Aid is provided through projects and programs with eligible recipients, in accordance with the objectives of the Canadian foreign policy and the Official Development Assistance program, which are within the general categories of economic and development assistance.

Program finance staff charged the grants to the multilateral-institutional-funding channel, which "promotes sustainable development and supports humanitarian assistance by providing core funding support and support to multilateral institutions and by providing funding for global programs of multilateral institutions." For example, CIDA gave a grant to the Inter-American Development Bank for the implementation of a new procurement system for the Government of Nicaragua. Although this initiative could be interpreted as belonging to the bilateral-aid channel-of-delivery, it was charged to the multilateral-institutional-funding channel by CIDA program finance staff.

5.45 The Framework Policy calls for the use of contributions when funding the bilateral-aid channel. All proposals for exceptions are to be submitted to the Vice President, Human Resources and Corporate Services, who must undertake appropriate consultations before recommending to the Executive Committee and the President that the minister approve the exception. For the three grants that could be considered as being under the bilateral-aid channel-of-delivery, there was no indication on file that CIDA officers followed the required procedure for exceptions to the policy by obtaining proper approvals for this channel-of-delivery. The three grants were coded to another channel-of-delivery that did not require special approval.

5.46 Given the broad definitions of channels-of-delivery, we are concerned that grants may be used for bilateral aid without proper authorization because they have been improperly categorized.

5.47 **Recommendation.** CIDA should continue publishing specific criteria for individual channels-of-delivery in program documents. The channels-of-delivery should be defined more precisely and should be clearly documented in grant files. CIDA officers should obtain proper authorization for bilateral grants.

CIDA's response. CIDA agrees with this recommendation. While the Agency believes that its files almost invariably identify accurately the channel-of-delivery through which its grants are made, the Agency also acknowledges the importance of having well-defined channels-of-delivery and ensuring that the channel-of-delivery is accurately identified in project files. Accordingly, by 1 February 2005, the Agency will review the current definitions and incorporate any changes in definition into documents such as the Manager's Guide to Contribution Agreements and the Explanatory Notes for the Delegation of Selection Authorities and Contractual and Financial Signing Authorities Document. Training courses will also be adapted to emphasize the channels-of-delivery.

The rationale for using a grant rather than a contribution was often unclear

5.48 The objective of the Treasury Board's Policy on Transfer Payments is to ensure sound management of, control over, and accountability for transfer payments. It requires departments to establish policies and procedures to ensure that proper program and other relevant documents are maintained to provide documentary evidence of decisions made.

5.49 Grants require less accountability than contributions (Exhibit 5.4). CIDA assumes a greater risk the recipient will not meet the goals of the program than it would if it used a contribution funding mechanism for the same initiative with the same recipient.

5.50 For the eight files that we looked at, we found that in most cases CIDA had not specified the reason for using a grant rather than a contribution. In our sample, we found that six of the eight recipients had received funding in the past. In all of these cases, CIDA had previously used contributions. One recipient had been receiving funding through contributions for about 20 years. In 2000, this recipient had, for the first time, received grant funding. We noted other cases involving recipients who had been receiving funding primarily through contributions until 2001, but who have since begun to receive grants. The files we examined did not contain an analysis of how the change in funding mechanism would affect expected results or the reasoning for using the grant mechanism. We recognize that the principles behind the policy statement on strengthening aid effectiveness may favour greater use of grants than in the past. However, we still expect that the merits for using grants instead of other funding mechanisms and the effect on the expected result would be clearly evaluated and documented for each case. This is especially important as the grant mechanism does not impose any conditions on the recipient.

5.51 We are concerned that, without having assessed the probable effect on the expected development results, CIDA may be sacrificing a degree of control and oversight over how recipients spend CIDA funding.

5.52 **Recommendation.** The rationale for choosing a grant as the mechanism for funding a project should be documented and clearly explained in terms of the degree of desired control and the effect on the expected results.

CIDA's response. CIDA agrees with this recommendation and, by 1 February 2005, will develop criteria to determine when to use a grant or a contribution and the rationale for this choice in view of the need for appropriate controls and the effect on expected results. These will be incorporated into managerial guides and training courses on the management of grants and contributions.

CIDA has disbursed grant funds in advance of need

5.53 CIDA's Terms and Conditions for International Development Assistance state that the Agency should schedule instalment payments of grants to recipients according to their cash-flow requirements. However, exceptions are permitted. CIDA may pay grants in a single instalment in circumstances such as emergencies, or when required by Canada's overall foreign policy interests.

5.54 We found that for seven of the eight cases we looked at, CIDA had disbursed the entire grant as a single payment rather than in instalments. For six of those seven cases, we believe that CIDA could have disbursed the funds in instalments. In these six cases, CIDA had not demonstrated in its files its reasons for making an exception.

5.55 For example, CIDA advanced full payment of $2 million for a five-year membership in a newly established Advisory Centre on World Trade Organization Law because it had the funds available in that fiscal year. The entity's financial regulations allow for membership payments to be made in five, equal, annual instalments.

5.56 **Recommendation.** CIDA should respect the government's transfer payment policy and the Terms and Conditions for International Development Assistance when paying grants in a single instalment. The rationale for making an advance payment in a single instalment, which does not reflect the recipient's cash-flow needs, should be properly documented.

CIDA's response. CIDA agrees that all payments of grants should fully respect the Treasury Board Policy on Transfer Payments and the Terms and Conditions for International Development Assistance. To guard against the possibility of payments exceeding the immediate cash flow requirements of grant recipients, financial staff assigned to program delivery branches will be required to sign off on each grant payment to ensure that it is consistent with the Treasury Board policy. Training courses will also be modified to emphasize Treasury Board policy.

CIDA is working to provide guidance on administering grants

5.57 CIDA recognized the need to develop material to guide staff in using and managing grants. In September 2003, the Contracting Management Division made available a draft copy of the Manager's Guide to CIDA Grants. This document discusses grant-related roles and responsibilities and provides information in areas such as using, approving, and managing grants. It also provides partial guidance on selecting a channel-of-delivery. CIDA staff told us that more work on the guide—including communication activities, developing a training course, and developing a grant template agreement—is in progress.

Financial compliance audits

5.58 In 1999 we examined the financial compliance audits that the Contract and Contribution Audit Unit had carried out on behalf of CIDA. In 2000 the Contract and Contribution Audit Unit was re-named the Financial Compliance Unit.

5.59 The main objective of these audits was—and continues to be—to make sure that all expenditures claimed by a Canadian executing agency are properly documented and comply with the terms and conditions of its agreement with CIDA. Financial Compliance Unit auditors identify possible ineligible expenses and refer them to CIDA staff for action (see Exhibit 5.6). Given the wide range of projects, the dollars involved, and the variety of documentation that supports recipient claims under the contract and contribution agreements, these audits are a key control for maintaining financial probity.

5.60 Our 1999 audit observed that the amounts identified as **audit adjustments** totalled \$32.2 million or about three percent of the total value of expenditures claimed. The Contract and Contribution Audit Unit auditors

Exhibit 5.6 Terms CIDA uses in its financial compliance audits

CIDA uses certain terms relating to the results of financial compliance audits and how the organization deals with them.

Audit adjustment—an item that an auditor identifies as an ineligible expenditure, that is, an expenditure not supported by proper documentation or not allowed under the terms of an agreement.

Release—a decision resulting from further investigation and negotiation between CIDA and an executing agency, that an audit adjustment is an eligible expenditure, for which CIDA will pay.

Maintained adjustment—a decision that CIDA will not pay for an item because it does not comply with the agreement. Therefore, it represents an ineligible expenditure, which CIDA will recover from the executing agency.

had found persistent non-compliance problems and had identified a number of adjustments. We then looked at CIDA's **release** decisions to determine whether they had been justified and whether Canadian executing agencies had supported their claims with adequate documentation, such as proper receipts and other records.

5.61 We found that CIDA staff had released a high proportion of ineligible expenses that Canadian executing agencies had claimed, even though these agencies had not provided adequate documentation or other evidence to support their claims. We concluded that CIDA's releases were not always justified. We also found that certain standard clauses in the agreements were ambiguous. We noted that CIDA should clarify these clauses to reduce uncertainty and the risk of misinterpretation that could, in turn, lead to adjustments.

5.62 Since 1999, CIDA has acted on our recommendation to clarify key clauses in its agreements. The Contracting Management Division developed standard agreements for CIDA's geographic programs, and it is working to standardize all agreements across the Agency. The Financial Compliance Unit has also instituted the practice of initial visits; CIDA staff meet with Canadian executing agencies at the beginning of projects to clarify requirements for financial reporting and acceptable evidence to support a claim.

Justification for releases has improved since 1999, but problems persist

5.63 Despite these improvements, we noted a lack of independent oversight over the release of adjustments identified by financial compliance audits. The audit adjustments propose corrections for errors in payments to Canadian executing agencies that the project officer or program manager had previously approved under section 34 of the *Financial Administration Act*. Financial officers are involved in the internal discussions as to whether or not to release the adjustments, at times actively challenging the decisions made by the program staff. However, prior to the release of the adjustment, they provide no formal review or approval comparable to when they sign off under the *Financial Administration Act* for the initial payment. It is the program officer or manager who at this stage of the process again has the primary responsibility for making the final decision to release an audit adjustment. This decision is made after review and negotiation with the Canadian executing agency and in consultation with the Financial Compliance Unit, which plays an advisory role in the release process.

5.64 In 1999, only about 12 percent of CIDA's release decisions were justified and well-supported with documentation. Our follow-up examined a sample of 20 Financial Compliance Unit audit files (including 14 chosen statistically), from a total of 391 audits where CIDA had made a decision as to the release or maintenance of the proposed audit adjustments reported from 1 April 2000 to 30 September 2003. The follow-up showed that just fewer than 50 percent of the files that were reviewed showed proper justification and documentation for release decisions. Although this represents an improvement since 1999, our audit found that problems persist with unjustified and/or inadequately documented releases of audit adjustments. Given our initial findings from 1999, we would have expected to see a more formalized role played by financial officers in approving the release of audit adjustments such as an independent sign-off for the release.

5.65 In this follow-up, we observed that, overall, the amounts identified as audit adjustments by financial audits initiated from April 2000 to September 2003 totalled $33.5 million or about three percent of expenditures claimed. CIDA officers released audit adjustments of $12.2 million, **maintained adjustments** of $9.1 million in ineligible expenditures, and had not yet made a decision on the remaining $12.2 million in audit adjustments. In our sample, we found a number of releases where claimed expenses clearly fell outside the terms of the agreements between CIDA and its Canadian executing agencies. By granting those releases, project officers and program managers allowed the claims. Section 34 of the *Financial Administration Act* requires that payments are made only for goods received and services rendered as per the contractual terms of the agreement. CIDA officers did not contravene section 34 of the *Financial Administration Act*. However, for a number of release decisions, CIDA ultimately did not ensure that it paid only for those goods received and services rendered according to the terms of the agreement. Accordingly, CIDA should have maintained these adjustments, amended the agreement, or sought appropriate authority for the release. CIDA has no clear guidelines for these situations, as to who may approve the releases or how appropriate authority should be exercised. Exhibit 5.7 provides examples of cases where project officers and/or program managers accepted expenditures that were outside the terms of the agreement.

5.66 We also noted that, in a number of cases, the rationale for the release was on file, but the documentation to support it was missing or inadequate. In our view, release decisions should be based on supporting evidence that is

Exhibit 5.7 Examples in which adjustments were released without assurance that goods and services were received as per agreement

Unauthorized releases by CIDA officers of audit adjustments for amounts that were outside the terms of the agreement	Inadequate documentation to support release decisions
Two audit adjustments were released for reimbursable costs claimed by a Canadian executing agency for its contractors, at the higher rates applying to its employees. An audit adjustment was released for salaries claimed separately by a Canadian executing agency. These costs were already included in an overhead allowance provided under the agreement. An adjustment for overtime costs that were in excess of the salary budget allowed in the agreement was released.	An adjustment for a travel advance claimed was released based solely on a financial statement submitted by the Canadian executing agency that did not indicate whether the advance had been spent. An adjustment relating to salaries paid for work on statutory holidays and annual vacation was released without proof that the employees were present on those days.

commensurate to that required by the Financial Compliance Unit auditors during the initial audit. Releasing an adjustment without sound, well-documented reasons and without supporting evidence means that CIDA may be paying for unauthorized items. Examples of poor documentation to support the release decision are shown in Exhibit 5.7.

5.67 A cutback made in the number of planned Financial Compliance Unit audits may weaken this important control over expenditures. In October 2000, CIDA's Management Committee made it mandatory that all agreements of more than $3 million be audited after the first year of operation. CIDA expected that the audits would identify any emerging contractual and administrative problems more quickly. However, for budgetary reasons, CIDA dropped these audits, along with random reviews, from the Financial Compliance Unit's audit plan for 2003–04, although both were important elements in CIDA's risk-based audit framework. We also noted that the number of financial compliance audits planned for the 2003–04 year had been substantially reduced. This reduction contrasted sharply with the trend that had occurred over the previous four years toward more audit coverage. We are concerned that CIDA's cutbacks in the work done by the Financial Compliance Unit may result in less compliance with agreements by Canadian executing agencies and fewer recoveries of overpayments.

5.68 As we said in 1999, compliance audits are an important financial control, and CIDA needs to be more insistent about maintaining adjustments and about challenging Canadian executing agencies with respect to expenditures that do not comply with their agreements. This audit indicates that despite some improvement, CIDA's current practices for dealing with audit adjustments need strengthening.

5.69 **Recommendation.** CIDA should ensure that every release is properly and independently authorized and that adequate supporting documentation is on file to justify the release.

CIDA's response. CIDA agrees with this recommendation. Accordingly, by 1 February 2005, the Agency will require that the Finance Division's Financial Compliance Unit formally sign off on each audit adjustment that is to be released. A condition of this sign-off will be that adequate documentation supporting a release be available on file.

While CIDA's financial situation in 2003–04 necessitated budget reductions in most of the Agency's operations, including the Financial Compliance Unit, the budget of the Unit was completely restored at the outset of 2004–05. The reinstatement of funding underscores the Agency's commitment to ensuring the effectiveness of the Financial Compliance Unit.

Counterpart funds

5.70 In two previous reports (1998 and 2000) we raised concerns about CIDA's control over counterpart funds. Exhibit 5.8 explains the basics of the counterpart fund concept.

5.71 We raised concerns in 1998 about the need to revise or update the policy and guidelines for managing counterpart funds, particularly with respect to dealing with cases in which products had not been fully monetized. CIDA agreed to strengthen its procedures in this area.

5.72 In our October 2000 audit of CIDA, we again noted monetization gaps, that is, where recipient countries had not deposited the full amount of money owed to their counterpart funds even though they had agreed to do so. CIDA agreed to scrutinize funds more consistently and "take appropriate action where needed."

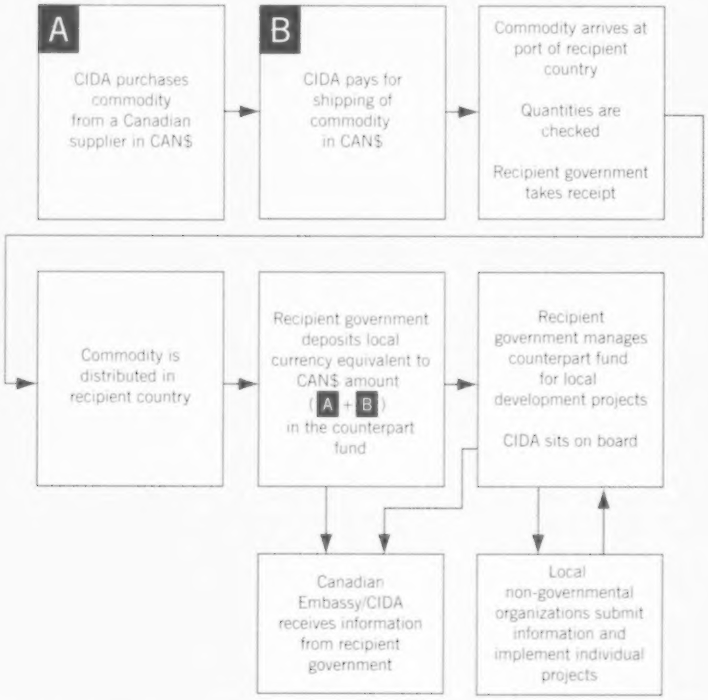
Exhibit 5.8 Counterpart funds and monetization

Counterpart funds are well-established funding mechanisms that enable CIDA to convert Canadian goods into funding for locally-managed aid projects.

Under counterpart funding, CIDA buys a commodity (for example, wheat) from a Canadian supplier. When the recipient government or a local purchaser takes possession of the product, the government must then deposit into a counterpart fund an amount of local currency equivalent to what CIDA originally paid the Canadian supplier for the product, plus shipping costs. In doing so, the recipient government is monetizing that commodity. Where a government deposits the full equivalent amount, the commodity is considered fully monetized. In some cases, CIDA allows the recipient government to deduct a small amount for its administration costs.

The fund, known as a counterpart fund, is used by the recipient government to finance local development projects. CIDA often has representation on the board of directors of the fund.

Typical operation for a counterpart fund


A
CIDA purchases commodity from a Canadian supplier in CAN$
B
CIDA pays for shipping of commodity in CAN$
Commodity arrives at port of recipient country
Quantities are checked
Recipient government takes receipt
Commodity is distributed in recipient country
Recipient government deposits local currency equivalent to CAN$ amount (A + B) in the counterpart fund
Recipient government manages counterpart fund for local development projects
CIDA sits on board
Canadian Embassy/CIDA receives information from recipient government
Local non-governmental organizations submit information and implement individual projects

Source: CIDA and our reports.

respect to dealing with cases in which products had not been fully monetized. CIDA agreed to strengthen its procedures in this area.

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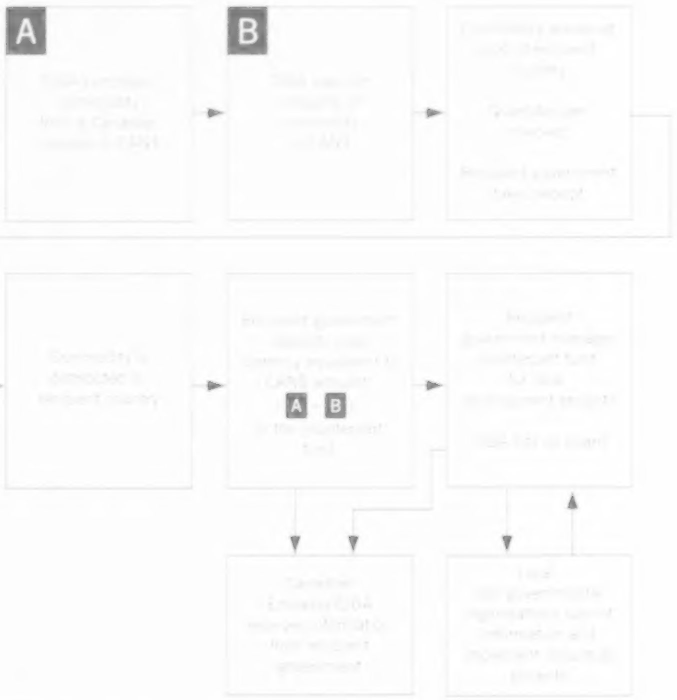
A
CIDA purchases commodity from a Canadian supplier (CAN$)
B
CIDA pays for shipping of commodity (CAN$)
Commodity is delivered to recipient country
Quantities are checked
Recipient government takes receipt
Commodity is distributed in recipient country
Recipient government deposits local currency equivalent to CAN$ amount
A + B
in the counterpart fund
Recipient government manages counterpart fund for local development projects
CIDA sits on board
Canadian Embassy/CIDA receives information from recipient government
Local non-governmental organizations submit information and implement local projects

Source: CIDA and our analysis

5.73 CIDA has not yet updated its 1994 policy and guidelines for managing counterpart funds, although in 1998, 2000, and again in 2003, it made commitments that it would update its Counterpart Fund Policy. The Agency noted that the revised, updated policy would address the issues of accountability and management raised by the Office of the Auditor General and internal CIDA audits. As of October 2004, the new Policy and Guidelines for the Management of Counterpart Funds remained in draft form.

5.74 We noted that CIDA's Internal Audit directorate has not audited any counterpart funds since 1998. Nor has it done any follow-up to determine what the Agency has done to respond to problems noted in two of its previous audits of counterpart funds. Internal audit staff told us that they have been waiting for a new counterpart fund policy before undertaking more work on these funds.

5.75 The 1994 counterpart fund policy requires program managers to submit brief annual reports to CIDA's Policy Branch on the counterpart funds for which they are responsible. The purpose of these reports was to enable the Agency to centrally collect data on counterpart funds. We found that managers have not submitted these reports as required. The branch had not received any of these reports in three years. In our view, the lack of current and adequate information compromises the Agency's ability to monitor counterpart funds properly and to account for their results.

Monetization gaps were minor

5.76 In 2000, we found two out of six funds, for which the recipient countries had deposited less than 100 percent of the monetized value of commodities, contrary to CIDA policy. We again examined six funds for the follow-up. CIDA was unable to produce documentation that should have been on its files relating to the fund that operated in Haiti. The situation in Haiti prevented CIDA from reconstructing the documentation from other sources. We were thus unable to determine if and when the funds were deposited for that counterpart fund. For the remaining five funds audited, other than minor variances relating to exchange rates, we found that full equivalent value had been deposited in accordance with CIDA policy. For two of the remaining five funds, we could not determine whether the countries had deposited the money according to the agreed-upon schedule because CIDA could not provide us with the necessary information (Exhibit 5.9).

5.77 With respect to the funds in Mali and Bangladesh, the exchange rate that those governments used to determine how much to deposit into the counterpart fund differed from the rate we obtained from an independent source. The differences in rates for Mali translated into potentially 2.7 percent less of the value of purchases from Canadian suppliers (about $380,000 out of $13.8 million). For Bangladesh, the differences translated into potentially 1.3 percent less than the value of purchases from Canadian suppliers (about $560,000 out of $43.2 million). We could find no evidence on file that CIDA had verified that the exchange rates used for monetization were acceptable.

Exhibit 5.9 Problems with monetization for projects we examined

Counterpart fund/finding	Deposit less than 100% value	Potential deposit differential due to exchange rates used	Timing of deposits
Haiti	No documented evidence available	No documentation available	No documentation available
Mali	No problem noted	About $380,000 less	Unable to determine exact date of deposits from documentation on file
Bangladesh	Deposited at less than full value, but justified as per CIDA policy requirements	About $560,000 less	No problem noted
Mauritania	No problem noted	No problem noted	Unable to determine exact date of deposits from documentation on file
Philippines	No problem noted	No problem noted	No problem noted
Cambodia	No problem noted	No problem noted	No problem noted

5.78 In our view, the CIDA managers responsible for the monetization of the funds where problems were noted did not demonstrate sufficient vigilance in implementing CIDA policy.

5.79 **Recommendation.** CIDA should update its policy on the monetization of counterpart funds without delay. The new policy should make clear the acceptable boundaries for monetization and address issues such as exchange rates and the required timing of deposits.

CIDA's response. CIDA's draft counterpart fund policy update is currently scheduled to be presented to the Policy Committee for approval before 1 February 2005.

The draft policy indicates that CIDA must justify the percentage of the value of goods and services provided in Canadian dollars that is to be collected in local or foreign currency. It also stipulates that the bilateral arrangement between CIDA and the recipient government must define, among other things, how to determine the exchange rate between the value of the goods or services in Canadian dollars and in local or foreign currency, as well as the timing of deposits of local or foreign currency into the Counterpart Fund account.

Conclusion

5.80 The results of this follow-up audit indicate that CIDA has made satisfactory progress on the key issues we raised in previous years, such as the use of sole-source contracting, monetization of counterpart funds, clarification of key clauses in agreements to reduce ambiguity, and monitoring of project risks. While some areas still need attention, overall, CIDA has made satisfactory progress on our recommendations.

5.81 CIDA has made efforts to provide direction on the appropriate use of sole-source contributions and contracts. We found that as a result, the unjustified use of sole-source agreements diminished significantly. CIDA needs to make further efforts to ensure that the spirit and the letter of its own and government policies are being respected.

5.82 CIDA has improved its project management by including clauses in agreements to make Canadian executing agencies more responsible for the sustainability of project benefits. The Agency has also improved its risk management of projects.

5.83 CIDA conducts a number of audits to ensure that Canadian executing agencies comply with the terms and conditions of the contract and contribution agreements. Those audits recommend the recovery of unjustified or improperly documented amounts that CIDA has paid. Frequently, CIDA decides to release the Canadian executing agency from the requirement to repay some of those amounts. CIDA has clarified its standard agreement and shown some improvement in documenting and justifying those release decisions. However, we are concerned that in the files we audited, half of those release decisions made were still unjustified or not properly documented. In these cases, we believe that CIDA is in effect deciding to pay for items where it is not apparent that the goods were received or the services rendered according to the terms of the agreement.

5.84 For counterpart funds, CIDA has shown substantial improvement in this area as the problems we found were minor compared to those found in the previous audits.

5.85 During the course of our audit, we observed that CIDA is increasingly using grants as a funding mechanism. We note there are cases of CIDA using grants where it formerly used contributions to fund projects. While the use of grants is consistent with CIDA's recent approach to partnering with other donors, for the cases we audited, the rationale—in terms of obtaining better developmental results—was not on file for using a grant rather than a contribution. In addition, CIDA had not properly justified disbursing grants in advance of need.

About the Follow-Up

Objectives

The primary objective of this follow-up was to assess what CIDA has done to address issues and recommendations that were raised in two of our previous reports: Chapter 28 of the November 1999 Report and Chapter 14 of the October 2000 Report.

Scope and approach

The follow-up focussed on four main areas addressed in our previous chapters:

- **Contractor selection.** Our examination focussed on the process for selecting contracts, contribution agreements, and grant agreements related to aid projects. Using a risk-based approach, we selected for audit non-statistical samples of 5 non-competitive contracts, 19 contribution agreements, and 8 grant agreements. Our samples were chosen from aid agreements that were over $100,000 in value and that had been entered into between January 2001 and August 2003. During this period, those agreements included over 40 non-competitive contracts totalling about $110 million, over 1,400 contribution agreements totalling about $2.1 billion, and 755 grant agreements worth about $1.6 billion.
- **Non-compliance with contracts and contribution agreements—Financial Compliance Unit.** We looked at how CIDA had dealt with the results of financial compliance audits. Overall, the amounts identified as audit adjustments by financial audits initiated from April 2000 to September 2003 totalled $33.5 million or about three percent of expenditures claimed. We reviewed a sample of 20 audit files chosen from 391 financial compliance audits initiated between 1 April 2000 and 30 September 2003 for which a decision about the release or maintenance of the proposed audit adjustments had been made by CIDA. These included a statistical sample of 14, chosen through the use of the statistical Chi-squared sampling methodology, in order to evaluate whether or not CIDA had improved its documentation and justification of release decisions since our previous audit.
- **Controls over payments into counterpart funds.** We examined and assessed six out of approximately 23 counterpart funds (including some for which we had reported problems in 1998 and 2000) to determine what CIDA had done to strengthen financial management controls over counterpart funds.
- **Implementation of agreements.** The 2000 audit raised a number of issues around how well contracts and contribution agreements had been executed. In our follow-up field visits, we examined CIDA's and the executing agency's processes for managing project risks and critical assumptions, for ensuring project sustainability, and for terminating projects. We examined and made visits to 10 projects in the Philippines, Egypt, and Cuba.

From the 1999 report, we followed up on the following:

- **The results of audits.** Whether or not CIDA had clarified standard contract clauses to reduce ambiguity, and whether CIDA maintained audit adjustments unless the recovery of the unauthorized expenses was clearly not cost-effective.
- **The role of performance review.** Whether or not the Performance Review Branch (now the Performance and Knowledge Management Branch) had periodically assessed the Financial Compliance Unit audits of contracts and contributions to determine whether they are providing the required level of financial control.

Areas we did not follow up on were

- project financial controls, and
- the role of performance review in auditing the quality and accuracy of information reports by Canadian executing agencies.

From the 2000 report, we followed up on the following:

- **Agreement planning and design.** Provisions for sustainability.

- **Selection**. The use of non-competitive contribution agreements instead of competitive agreements, and the use of sole-sourced contracts.
- **Execution of agreements**. Controls over payments into counterpart funds, management of the assumptions deemed critical to project success, and building off-ramp provisions into agreements.

Areas we did not follow up on were

- the realism of the planned and expected project results, and
- Canadian Partnership Branch agreements.

Additional areas audited that relate to the issue areas followed up include the increased use of grant agreements for aid projects, CIDA's analysis of the value and existence of in-kind contributions by recipients of its contributions and the restriction that there be no profit, and the application of section 34 of the *Financial Administration Act* when dealing with audit adjustments.

We conducted our work at CIDA's headquarters and visited selected projects in the field. We reviewed project documentation and interviewed Canadian executing agencies and CIDA officials. We also reviewed CIDA status reports on how it has responded to our recommendations.

Criteria

The audit criteria from the 1999 and 2000 chapters remain relevant and were largely derived from CIDA's internal guidelines and from Treasury Board policies. We therefore expected to find the following:

- Treasury Board directives (including the Terms and Conditions for International Development Assistance and the associated Framework Policy approved by Treasury Board in 2001), Government Contracts Regulations, and CIDA internal policies should be respected.
- The contracting plan should contain an analysis of different options for the particular project, with competition being the norm.
- Contract and contribution performance should be monitored and evaluated against the terms and conditions of the agreement.
- Decisions to release financial compliance audit adjustments should be appropriately supported and taken at the proper decision-making level.
- Issues identified in audit reports should be analyzed, and corrective action taken as needed.
- Decisions to recover or write off amounts owed to CIDA should be documented and taken by the appropriate decision-making authority.

We also expected CIDA to have carried out the actions it had indicated it would take in response to previous observations and recommendations from our 1999 and 2000 reports.

Audit team

Assistant Auditor General: Shahid Minto
Principals: John Hitchinson and Paul Morse

Dusan Duvnjak
Roberto Grondin
Vivien Kaye
Jean Liu
Jennifer McLeod
Sophie Miller
Suzanne Moorhead

For information, please contact Communications at (613) 995-3708 or 1-888-761-5953 (toll-free).

Chapter

6

Canadian Nuclear Safety Commission

Power Reactor Regulation

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Canadian Nuclear Safety Commission
Power Reactor Regulation

Main Points

6.1 Overall, the Canadian Nuclear Safety Commission (CNSC) has made satisfactory progress in response to our recommendations from our December 2000 audit of power reactor regulation. However, progress has been slower than planned in developing a formal, well-articulated risk-management approach to power reactor regulation.

6.2 In response to that audit, CNSC posted an action plan on its Web site and updated it regularly. The action plan called for it to have a risk-based approach in place by the end of 2003. It is implementing a systematic, risk-informed regulatory approach to its activities for the regulation of nuclear substances and uranium mining and processing. However, the CNSC has only recently launched a program to develop a plan by March 2005 that, when implemented, will adopt this approach in its regulation of power reactors.

6.3 The CNSC has made satisfactory progress in implementing a consistent approach to compliance and enforcement within and across the divisions that plan and conduct compliance inspections of power reactors.

6.4 Since our 2000 audit, the CNSC has developed a new scale for rating the performance of power reactor licensees in meeting CNSC's regulatory expectations and has issued key regulatory documents. It has also implemented a process for assigning priorities among regulatory policies, standards, and guides to be developed. It has made satisfactory progress in addressing the human resources issues of capacity, recruitment, and retention of capable staff, and clarification of roles and responsibilities.

Background and other observations

6.5 The CNSC regulates the use of nuclear energy and materials to protect health, safety, the environment, and national security. Since our December 2000 audit, two events occurred that had a significant impact on the CNSC and underscore the importance of its role. The first event was the terrorist attacks on the New York World Trade Centre on September 11, 2001; this prompted an immediate re-evaluation of the security measures at Canada's nuclear facilities, and additional measures were implemented to improve security.

6.6 The second event was the power outage of 14 August 2003 that affected Ontario and the eastern United States. The CNSC participated in a Canada-U.S. joint task force that investigated the cause of the outage. The task force concluded that the nuclear power plants had not triggered or spread the power system outage and were maintained in a safe, shutdown condition until their restart.

6.7 After reviewing the structure of comparable regulatory organizations, the CNSC decided not to separate the role of CEO from that of chair of the Commission. It restructured the organization along business lines and clarified the roles of chair of the Commission and chief executive officer.

The Canadian Nuclear Safety Commission has responded. The Canadian Nuclear Safety Commission has responded to our observations and informs us that it is continuing with the improvements it began in response to our December 2000 recommendations.

Introduction

6.8 The *Nuclear Safety and Control Act* came into force on 31 May 2000, creating the Canadian Nuclear Safety Commission (CNSC) to replace the Atomic Energy Control Board. Like its predecessor, the CNSC is responsible for regulating the use of nuclear energy and materials in Canada to protect health, safety, security, and the environment. This includes the licensing and regulation of power reactors, the subject of an audit we reported in December 2000.

6.9 The Canadian Nuclear Safety Commission is a technically oriented organization that includes an operational staff component (CNSC) and an independent tribunal component (Commission). The operational component consists of more than 570 staff who conduct audits and inspections of licensed nuclear facilities. They also carry out detailed reviews of licence applications. On the basis of those reviews, the staff make recommendations to the Commission comprising up to seven government-appointed members chaired by the President of the CNSC, which makes the final licensing decisions for nuclear-related activities in Canada.

Darlington Nuclear Generating Station

6.10 In its fiscal year 1999–2000, the CNSC employed 440 staff and its costs totalled $59 million. Its headquarters are in Ottawa, and it maintains a site project office at each of the five nuclear generating stations, where its staff monitor the licensee's compliance with regulations and with the licence conditions. Canada has 22 power reactors: 20 in Ontario, 1 in Quebec, and 1 in New Brunswick. At the time of the follow-up audit discussed in this chapter, the CNSC had about 510 staff; its total budget for the fiscal year 2003–04 was $76 million.

6.11 The activities of licensing and regulating power reactors account for nearly half of the CNSC's resources and represents its most significant responsibilities, given the risks to public health and safety should a major accident occur.

6.12 In its Annual Report for 2001–02, the CNSC highlighted the work it had undertaken in the aftermath of the September 11 terrorist attacks in the United States. Immediately following those events, it had conducted a comprehensive re-evaluation of security measures in place at nuclear facilities. Additional measures were implemented to increase security at Canada's nuclear generating stations and other facilities. The CNSC reported that it would continue investigating possible security measures to ensure the continued safety of Canadians.

6.13 In its Annual Report for 2003–04, the CNSC referred to the power outage of 14 August 2003 that affected Ontario and the eastern United States. A Canada-U.S. joint task force concluded that the nuclear power plants in both countries had not triggered the power outage or its spread. The task force's Nuclear Working Group also concluded that safety functions had been effective and the affected nuclear power plants had been maintained in safe, shutdown conditions until their restart.

Focus of the follow-up

6.14 In December 2000 we reported that the Canadian Nuclear Safety Commission needed to improve its regulatory regime to ensure that it continued to protect the health and safety of Canadians (December 2000 Report, Chapter 27, Canadian Nuclear Safety Commission—Power Reactor Regulation). Following the tabling of our chapter, the House of Commons Standing Committee on Public Accounts (PAC) held a hearing and issued its Seventeenth Report. Its recommendations further supported our observations and recommendations. In response to our audit, reinforced by the PAC report, CNSC posted its action plan, to address the recommendations on power reactor regulation, on its Web site and updated it regularly. In fact, it concluded that the recommendations also applied to other activities, and it undertook to implement the recommended changes across the CNSC, including activities in the regulation of nuclear substances and uranium mining and processing.

6.15 The objective of our follow-up audit was to determine the extent of CNSC's progress on implementing our recommendations to improve its regulatory regime for power reactors. We also wanted to determine its progress on implementing the recommendations in its other service lines: Nuclear Substance Regulation and Nuclear Cycle and Facilities Regulation. We did not examine the security aspect of CNSC's responsibilities. The scope and criteria for this follow-up audit are outlined at the end of the chapter in **About the Follow-Up**.

Observations

Organizational changes since 2000

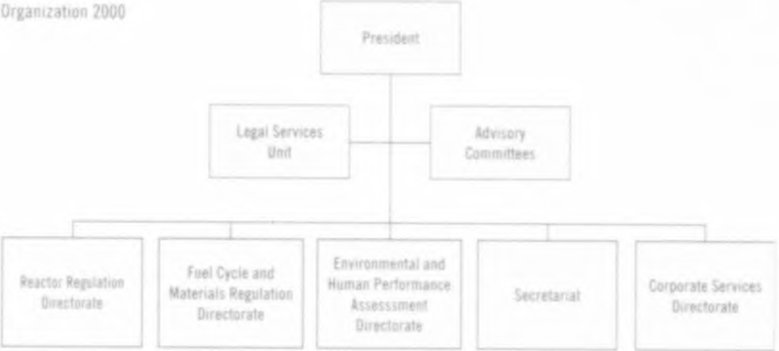
6.16 Since our December 2000 audit, the CNSC has made organizational changes to improve decision making. The Executive Vice-President of Operations is now accountable for five directorates—the three regulatory service lines (power reactors, nuclear substances, and uranium mines and facilities), an assessment and analysis group, and a regulatory documents and program improvement group (Exhibit 6.1).

6.17 The CNSC also formed a secretariat that is separate from the operational staff groups and that provides support to the Commission members. The Commission Secretary heads the secretariat and has a mandate to maintain the separation between the CNSC operations staff and the Commission members. The changes to the organization have improved CNSC's operations and provided separation between the operations and support functions of the CNSC and the Commission.

6.18 The CNSC also developed a revised program to recover its costs, with new fees regulations, which became effective in July 2003. The new regulations are intended to make the financing of CNSC programs more equitable, in that licensees pay all or part of the costs of regulatory activities. The new fee structure requires the CNSC to inform licensees about its planned regulatory activities, the costs of those activities, and the applicable fees, before each fiscal year when the fees are to take effect. This will impose greater discipline on regulatory activities and move the CNSC toward a more risk-based approach to regulation. With fees based largely on planned work activities, licensees will expect the CNSC to demonstrate that it is directing its resources to licensing and compliance activities in areas of higher risk and priority.

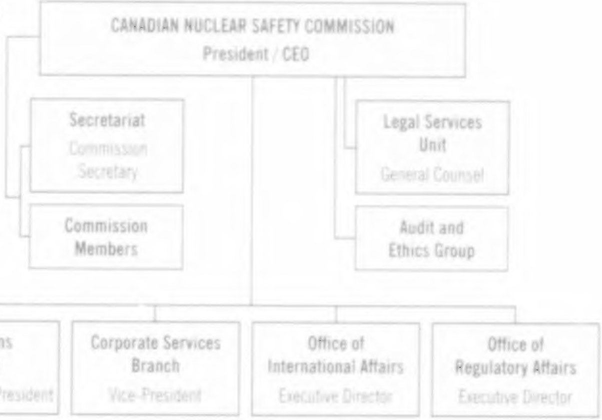
Exhibit 6.1 CNSC organization in 2000 and 2004

Organization 2000


President
Legal Services Unit
Advisory Committees
Reactor Regulation Directorate
Fuel Cycle and Materials Regulation Directorate
Environmental and Human Performance Assesssment Directorate
Secretariat
Corporate Services Directorate

Source: CNSC Annual Report 2000-01

Organization 2004


CANADIAN NUCLEAR SAFETY COMMISSION
President / CEO
Secretariat
Commission Secretary
Commission Members
Legal Services Unit
General Counsel
Audit and Ethics Group
Operations Branch
Executive Vice-President
Corporate Services Branch
Vice-President
Office of International Affairs
Executive Director
Office of Regulatory Affairs
Executive Director

Source: CNSC Annual Report 2003-04

Risk assessment and performance reporting

6.19 In 2000 we reported that

- the CNSC's regulatory activities were not based on a rigorous, well-documented system of risk analysis; and
- its ratings of the safety performance of licensees were not clear and understandable to all stakeholders.

6.20 CNSC staff assess the programs and performance of each licensee in meeting its regulatory expectations. CNSC refers to this as safety performance. It covers nine areas: operating performance, design adequacy, equipment fitness for service, emergency preparedness, environmental performance, radiation protection, nuclear security, safeguards, and performance assurance.

Implementing a systematic, risk-informed approach to regulatory activities

6.21 In 2000 we expected that the CNSC would base its regulatory activities on an analysis of relevant risks, the results of previous regulatory activities, and a rigorous, well-documented process linking activities to required results. A few CNSC divisions had developed formal approaches to risk analysis as a basis for proposing regulatory activity. Divisions involved in regulation of power reactors, however, had used an intuitive approach, relying on the judgment and expertise of staff. Safety performance indicators were not yet applied along with judgment and expertise in any systematic, integrated way to determine the nature or level of the work to be done. Without this type of analysis, the CNSC could not demonstrate whether it was doing enough or too much work in any area and whether it was overstaffed or understaffed.

6.22 In this follow-up audit we found that the Operations Branch had decided to implement an integrated, risk-informed approach to regulatory activities in phases, by branch service line. It started with the regulation of nuclear substances, then the regulation of uranium mining and processing. The next phase is to apply the approach to power reactor regulation; the final phase will integrate the allocation of resources on a risk-informed basis across the Operations Branch.

Satisfactory progress in regulating activities for nuclear substances and uranium mining and processing

6.23 **Nuclear substances.** The Directorate of Nuclear Substance Regulation conducts licensing and compliance activities for about 3,500 licences, classified into 90 types of use. These licences cover nuclear substances such as radioisotopes for medical uses and radiation devices widely used in research and industry. The Directorate has developed and is implementing a systematic approach that ranks risks and assigns priority and resources according to risk level. The risk management program for the Directorate is to be implemented over several years.

6.24 The 90 use-types were ranked in three distinct risk groups. Based on their safety performance, licensees were assigned to a risk group. The ranking is used to determine the levels of effort and resources needed to manage licensing and compliance activities, which include verification, enforcement, and promotion of licensees to a better ranking. Based on rankings, the Directorate has established the levels of resources and effort needed in compliance inspection activities for all use-types.

6.25 **Uranium mining and processing.** The Directorate of Nuclear Cycle and Facilities Regulation developed a systematic, risk-informed process to help managers decide where to allocate resources. It used a series of internal workshops and extensive consultation with facility and subject matter experts in the Operations Branch to rank the licensed facilities.

6.26 The Directorate then recommended that regulatory effort be allocated to each facility's licensing cycle based on the facility's ranking. The recommendations will serve as a guide for the licensing and technical specialists to decide on the appropriate regulatory activities for each licensee. Using this structured approach in the planning of regulatory effort should improve the allocation of resources within the Directorate.

Developing a plan to improve power reactor regulation

6.27 Project officers and technical specialists together assess each nuclear facility to obtain assurance that the level of risk to health, safety, and the environment remains within the terms of the facility's licence. Specialists review documentation and conduct audits to assess the quality and reliability of key reactor components as well as the facility's safety analysis, radiation protection, operating performance, safety procedures, and management. The review is linked to the licence-renewal cycle and is intended to cover all of the CNSC's regulatory requirements for the facility.

6.28 In January 2004, the CNSC announced appointments in the Operations Branch to address the need for an effective and efficient, risk-based program for the regulation of power reactors. In May 2004 it established the Power Reactor Regulation Improvement Program to examine all aspects of regulation and establish a plan for improvement. The plan, when implemented, will base levels of regulatory activity on a formal, well-articulated approach to risk management. Six teams of directors were formed to propose plans for improvements in key areas:

- Planning and reporting
- Process management—compliance
- Process management—licensing
- Risk-informed approach
- Information management and communication
- Leadership/management and human resources

6.29 The teams began meeting in June 2004 to confirm areas for assessment. Proposals for areas for improvements were reviewed in September; an improvement plan is to be prepared by March 2005.

6.30 Although recent developments are encouraging, the original action plan posted by the CNSC on its Web site indicated that a risk-based approach would be implemented by the end of 2003. We are concerned about the slow progress and the absence of an approved plan setting out the approach, resources, accountabilities, deliverables, and timelines for developing a systematic, risk-informed approach to allocating the appropriate regulatory effort for each power reactor.

No formal plan for integration across the Operations Branch

6.31 The CNSC intends to ultimately integrate the risk-informed approach to regulatory activities for all its service lines to support a broad range of management decisions across the Operations Branch. In October 2002, the target date to complete this integration was December 2003. Achieving an integrated approach across the Operations Branch will depend on the success of improvements in the regulation of power reactors.

6.32 One of the working groups on the Power Reactor Regulation Improvement Program is developing guidance on risk management for regulatory activities across the Branch. This guidance will form part of the improvement plan to be in place by March 2005 that will include desired results, milestones, and accountabilities.

New safety performance ratings have improved communication with licensees

6.33 Assessing licensees' safety performance against the CNSC's requirements and expectations is an important element of the licensing process. The CNSC's staff rate performance against the requirements set out in the *Nuclear Safety and Control Act* and the expectations outlined in regulatory documents. Safety performance ratings of power reactor licensees are included as "report cards" in Commission members' documents for review at public hearings when licences are being renewed or reviewed. In addition, performance ratings are presented annually in the Annual Report on the Canadian Nuclear Power Industry, which is discussed at a Commission meeting and posted on the CNSC's Web site.

6.34 In 2000 we noted that in its licensing reports the CNSC assessed and categorized various aspects of performance as acceptable, conditionally acceptable, or unacceptable. However, it arrived at those ratings using criteria that were subjective. For example, "conditionally acceptable" did not convey whether and to what degree the licensee was managing safety properly and whether the licensee's action plans and progress were satisfactory. This lack of clarity contributed to uncertainty and misunderstanding about the adequacy of the licensee's safety performance.

6.35 In 2002 the CNSC introduced a new system for rating the safety performance of nuclear power plants. In the nine safety areas previously discussed, staff assess licensees' programs and their implementation according to five ratings:

- A—Exceeds requirements (consistently exceeds applicable CNSC requirements and expectations)
- B—Meets requirements (meets the intent or objectives of CNSC requirements and expectations)
- C—Below requirements (performance below requirements; improvement needed)
- D—Significantly below requirements (continued poor performance; corrective action required)

- E—Unacceptable (breakdown or loss of control; more stringent enforcement action required)

6.36 Whether the CNSC is conducting a site inspection or a comprehensive review, each assessment requires a performance rating. The ratings for each licensee are accumulated and become part of the overall ranking of its performance in each safety-related area.

6.37 The new rating scale has improved the clarity, transparency, and consistency of performance ratings to licensees, CNSC staff, and the public. Although it is a substantial improvement over the previous system, further refinements are needed to improve communication between the CNSC and licensees.

6.38 For example, some licensees do not have a clear understanding of the rating scale and how to move up the scale to a better rating. In January 2004, they asked the CNSC to clarify the basis for the ratings they had been given and to explain what improvements were needed to achieve better ratings. The CNSC met with these licensees in summer 2004 to respond to their concerns.

Compliance and enforcement

6.39 In 2000 we reported that the compliance and enforcement system had not been applied consistently across the CNSC and further work was needed to develop a more results-based and systematic approach. The CNSC needs regulatory documents, including policies, standards, and guides, to clearly explain its regulatory requirements to staff, licensees, and the public. The documents were either incomplete or had not been revised after the *Nuclear Safety and Control Act* went into effect.

Satisfactory progress on an integrated approach to compliance inspections

6.40 In December 2000 we noted that in response to internal audit recommendations, the CNSC had approved a compliance program policy and had developed a plan to implement it consistently across the CNSC. Compliance and enforcement programs were to identify regulatory requirements and communicate them to licensees; compliance and enforcement actions were to be applied consistently and effectively throughout the organization. According to the CNSC, this would lead to a more results-based, systematic approach, taking into account a licensee's past compliance history when deciding whether to increase or decrease the level of scrutiny in regulatory activities.

6.41 In 2003, the CNSC's Compliance and Licensing Director at one nuclear power facility initiated quarterly meetings for representatives of all divisions participating in inspections and audits at the facility. This initiative was a successful pilot project for co-ordinating work and communicating well across the licensing group and technical groups. Based on the favourable results of the pilot project, the Power Reactor Regulation Directorate established a requirement that all compliance and licensing divisions conduct similar quarterly meetings.

6.42 In our follow-up we found that the Operations Branch has made considerable progress toward defining a consistent compliance program for power reactors. It had compliance and licensing divisions meet quarterly to co-ordinate inspection plans for each site, and it assigned to division directors the responsibility for managing the inspection programs at their stations. As part of the new cost-recovery program, division directors explained 2003 year-end variances in their inspection programs with licensees. CNSC has informed us that it intends to continue this practice annually. In addition, directors of compliance and licensing divisions have started using consistent planning tools to identify significant issues at facility sites, and they formally take account of the facilities' past performance in shaping their compliance programs. In September 2004, the compliance and licensing divisions and other participating divisions met for the first time to review compliance and inspection programs across nuclear power stations.

6.43 The Power Reactor Regulation Improvement Plan is intended to contribute further to the compliance inspection programs by clarifying roles and responsibilities between divisions, developing a plan for documenting a risk-based approach to resource allocation, and resolving the inconsistencies that remain in the management of inspection programs.

Key documents published and system implemented for prioritizing others

6.44 The *Nuclear Safety and Control Act* was passed in 1997 and came into force on 31 May 2000. In December 2000 we reported that the CNSC had revised or developed only some of the regulatory documents that were needed to make the regulatory system transparent and effective, which would provide staff and licensees with a clear understanding of the regulatory requirements, the processes for monitoring compliance, and the rules of enforcement.

6.45 In April 2003, the CNSC formed the Regulatory Documents Steering Committee, comprising one director from each of the five Operations Branch directorates responsible for the service lines and technical lines. The Committee sets priorities for developing regulatory documents, and it monitors the production of documents in accordance with the approved process.

6.46 The CNSC has clarified the definitions of the types of regulatory documents, which include policies, standards, guides, and notices. It has published about 20 key regulatory documents; another 15 have undergone public consultation; and 10 are currently open for consultation. The Steering Committee has developed a list of 31 other high-priority documents. The purpose and scope statements for all of the remaining high-priority documents are nearing finalization.

6.47 These steps represent satisfactory progress since our audit in 2000.

6.48 In the past, the CNSC was inclined to develop its own regulatory documents rather than draw on the safety standards of other agencies, such as the International Atomic Energy Agency. In 2003 the CNSC informed the Agency that it intended to adopt or adapt existing documents in order to harmonize its regulations with world-wide standards.

Human resources management

Satisfactory progress on addressing human resources capacity

6.49 In 2000, we reported that the CNSC faced difficulties in recruiting and retaining scientific and technical staff. In May 2000, many positions in the organization were vacant—some of them key positions.

6.50 In addition to staff shortages, the CNSC, with its aging employee population, was facing a loss not only of leadership but also of high-level expertise in the nuclear industry, which had been acquired over many years.

6.51 Since our audit, the CNSC has strengthened its human resources capacity. It established an internship program for power reactor regulation in 2001 to hire university graduates. All eight candidates completed their two-year rotation assignments, and all accepted positions in the organization. Another group of interns started in 2003, and a third group started in 2004. CNSC plans to recruit new candidates for the internship program annually. One important aspect of the program is the placement and retention of interns as permanent employees. To date, CNSC has successfully retained them all. CNSC informed us that it recognizes that recruitment and retention of qualified staff is an ongoing challenge.

6.52 As a result of changes in the nuclear power industry and other fields of technology, well-qualified and experienced candidates became available for positions with the CNSC. The vacancy rate in the Power Reactor Regulation service line was at eight percent in 2000; by 2003 almost all of the vacant positions had been filled. Further, management was confident of attracting capable trainees and experienced candidates at more senior levels.

6.53 Although the CNSC has experienced a high level of turnover at the senior management and technical levels since 2000, through retirements and departures, the impact on the organization has been less than expected. This is due partly to the development of new regulations and a more structured management as well as the recruitment programs.

6.54 In 2001 the Human Resources Directorate developed a workforce sustainability strategy. This strategy recognized the aging of the workforce and the importance of ensuring that the CNSC had the technical and management talent it needed. At the time of our follow-up audit, the Directorate had numerous recruitment and retention initiatives planned and underway to address these issues.

A need to clarify accountability for communications with licensees

6.55 In 2000, the respective roles and accountabilities of the site project offices and the technical specialists at headquarters were not clearly defined and understood. For example, staff at site project offices were not certain who was responsible for taking the lead on specific issues, so the lead role was often assumed on an ad hoc basis. In the absence of a clear understanding and effective implementation of the centralized approach to planning and reporting, accountability was fragmented. It was difficult to reach consensus on the safety performance of each nuclear facility.

6.56 In our follow-up, we found that the respective roles and responsibilities of the CNSC's site project offices and its headquarters were more clearly defined and understood, due in large part to the restructuring of the organization in 2002. At that time, the Operations Branch assigned to each nuclear power facility a compliance and licensing director responsible for managing inspection activities at the site and related issues at headquarters in Ottawa. This has helped staff at both the site project offices and headquarters gain a clearer understanding of their respective roles and responsibilities.

6.57 The Power Reactor Regulation Improvement Program has several initiatives intended to strengthen the management of regulatory activities—for example, clarifying responsibilities and designating a single point of contact for communication with licensees, and planning and reporting on compliance activities with more consistency.

Clarifying the President's dual role

6.58 We noted in 2000 that the President of the CNSC was both the chair of the appointed Commission and the chief executive officer of operations staff, as required by the *Nuclear Safety and Control Act* enacted in 2000. At that time, we found that the combining of both functions contributed to long delays in implementing change and a lack of understanding between Commission members and CNSC staff on some regulatory issues.

6.59 In our follow-up we noted that to address these problems, in April 2001, the Secretariat was created to enhance the independence of the role of the President and the Commission. The Secretariat provides advice and support to Commission members and the President. This independence was further strengthened in July 2004 when the CNSC created the position of Executive Vice-President, Operations Branch. The Executive Vice-President acts as CEO when the President is not available to discuss an item with a licensee or when, in the President's view, it is inappropriate to do so because the matter for discussion is pending a Commission hearing. As chair of the Commission, the President will not meet with a licensee to discuss a matter to be heard before the Commission for up to 60 days before a hearing in order to avoid any perception of undue influence or lack of transparency.

6.60 The CNSC conducted a benchmarking study of domestic and international tribunals and found no comparable organizations that separate the role of chair of the tribunal from the role of the organization's chief executive officer. The CNSC told us that separating these roles could, in its view, seriously impair the Commission's ability to function and it could find no compelling reason to separate the two roles at this time. A few licensees told us that the President's dual role as chair of the Commission and chief executive officer of CNSC operations still presents a problem in resolving some issues prior to a Commission hearing. CNSC, however, continues to believe that licensees have full access to the President and the Executive Vice-President at all appropriate times.

Conclusion

6.61 Overall, the CNSC has made satisfactory progress in implementing several of the recommendations in our 2000 audit. The progress of a systematic, risk-informed approach to regulating nuclear substances and uranium mining and processing has been satisfactory, but developing the same approach to regulating power reactors has been slower than planned. A formal plan, due by March 2005, is expected to help in assigning levels of regulatory effort on the basis of well-articulated risk management, once it has been implemented.

6.62 The CNSC is making satisfactory progress on a compliance program to be applied consistently across nuclear-power-reactor facilities. Progress on assigning clear accountability for managing regulatory activities at power reactor facilities to the compliance and licensing directors is also satisfactory.

6.63 The CNSC has made satisfactory progress in addressing the need for regulatory documents. It issued key regulatory documents and put in place a process for assigning priorities among new regulatory policies, standards, and guides to be developed.

6.64 The CNSC has developed a new scale for rating the safety performance of power reactor licensees, which has improved its communication with them. It has committed to improving the consistency of its ratings and to communicating their basis more effectively to its staff and its licensees, along with the measures by which licensees can improve their ratings.

6.65 The CNSC has decided not to separate the roles of chair of the Commission and chief executive officer of CNSC operations at this time, and it has clarified its position on this issue.

6.66 Actions taken to address our recommendations on human resources management have been satisfactory.

Canadian Nuclear Safety Commission's response. The Canadian Nuclear Safety Commission remains strongly committed to ongoing improvements in the area of the focus of this audit, power reactor regulation, as well as in all other areas of regulation within the CNSC's mandate. In support of this, we have welcomed the efforts of the Auditor General in assessing the CNSC's performance in power reactor regulation in a systematic manner, in identifying strengths and weaknesses, and in providing advice on how improvements can be made. We believe the findings are fair and are consistent with the CNSC's pursuit of continuous improvement.

About the Follow-Up

Objectives

The objective of this follow-up audit was to assess the progress the CNSC has made since our previous audit in 2000 to improve its regulatory regime for power reactors to ensure that it continues to protect the health and safety of Canadians.

Our previous audit (December 2000 Report, Chapter 27) concluded that the CNSC's regulatory activities were not based on a rigorous, well-documented system of risk analysis, and the ratings it assigned to licensees for safety performance were not clear. We concluded that if the CNSC strengthened its risk analysis, completed the changes it had begun in compliance and enforcement, and took the necessary steps to ensure that it would have the human resource capacity needed in the future, the regulatory regime for power reactors would achieve its safety objective and other objectives.

Scope and approach

Our follow-up audit covered the recommendations in our December 2000 Report. The CNSC management decided that many of our recommendations on power reactor regulation also applied to other areas of its mandate. As a result, management has been implementing changes in the other service lines—Nuclear Substance Regulation and Nuclear Cycle and Facilities Regulation.

While our follow-up audit took into account CNSC's overall progress in implementing a risk-informed regulatory approach in other areas of its mandate, our primary focus was on the licensing and regulation of power reactors.

We interviewed senior managers and key staff responsible for nuclear regulatory activities in each of the five directorates in the Operations Branch and senior officials in the Corporate Services Branch. Included in the interviews were compliance and licensing directors responsible for site offices located at nuclear power stations. We also interviewed licensees, many of whom had been included in the 2000 audit, for their perspective on the CNSC's progress on the audit recommendations. We reviewed extensive documentation relating to the audit issues and numerous reports on other nuclear regulatory agencies. We reviewed key systems and processes used by the CNSC to plan, implement, and report on regulatory activities. During the follow-up, we kept senior management informed on our progress and our preliminary findings.

Most of our audit was conducted in December 2003 and January 2004. However, we also conducted limited audit work in September 2004 to assess more recent progress.

Criteria

We expected that the CNSC would have made satisfactory progress in implementing our recommendations. We assessed its progress using criteria consistent with and drawn from our criteria in the original audit.

CNSC's regulatory programs should be designed, organized, and implemented on the basis of

- a comprehensive analysis of health and safety risks, and sufficient staff, expertise, and resources;
- a comprehensive analysis of other regulatory regimes to address identified risks, including an assessment of the capabilities of industry and government, consultations with stakeholders, costs and benefits, and policies for maintaining transparency and public access to information;
- a clear statement of the respective responsibilities of government, industry, and other parties, and ongoing consultations with stakeholders;
- clear and comprehensive performance objectives or goals for each of the areas subject to regulation;
- clearly defined key performance data, measurement procedures and data to be used, and policies for government to have timely and unimpeded access to all necessary data;

- clear policies and procedures for ensuring compliance with and enforcement of Canadian laws and international standards (to which CNSC has agreed), for resolving complaints, and for reporting and remedying regulatory failures, including any penalties that may be imposed; and
- clear, accurate, comprehensive, and timely reporting to management and Parliament on the relevance of regulations, their effectiveness, and the cost of the programs.

Audit team

Assistant Auditor General: Nancy Cheng
Principal: Crystal Pace
Director: Joseph Reperto

For information, please contact Communications at (613) 995-3708 or 1-888-761-5953 (toll-free).

Chapter

7

Governance of Crown Corporations

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Governance of Crown Corporations

Main Points

7.1 Overall, progress in addressing the recommendations from our 2000 audit of Crown corporation governance has been unsatisfactory. Individual Crown corporations have strengthened their own governance structures and practices. However, improvements that we recommended to strengthen the overall governance and accountability framework have not progressed as quickly and as far as we had expected.

7.2 Still, we found fewer gaps in the collective skills and expertise of board members. We also found that the composition and operating practices of board audit committees had improved and that audit committees are operating more effectively than in 2000.

7.3 Indications that governance practices have either not improved or improved slowly include the following:

- It took more than three years for the government to address some of our key 2000 recommendations by starting the Treasury Board Secretariat review of corporate governance in February 2004.
- A revised process for appointing Crown corporation boards of directors, chairs, and chief executive officers (CEO) was announced in March 2004 but has not yet been fully defined and implemented.
- Board, chair, and CEO appointments still take too long and terms of board members are not adequately staggered.
- We found very little progress in assessing the capacities and skills needed by the government to review corporate plans and ensure the continued relevance of Crown corporation mandates.
- The responsibilities and expectations of the government regarding Crown corporations still need to be clarified.

Background and other observations

7.4 This chapter assesses the progress that the government and Crown corporations have made in dealing with the concerns we reported in 2000. It also discusses recent developments in corporate governance elsewhere and their possible implications for the governance and accountability framework of Crown corporations.

7.5 Developments in corporate governance are raising the expectations for publicly traded corporations. These developments have yet to be adapted to the governance practices expected of Crown corporations. The emerging private sector practices that we think are the most relevant to Crown corporations are the following:

- ensuring that the board plays a key role in its own renewal and in the selection of the chair and CEO;
- strengthening the independence of boards and audit committees;
- requiring that the mandate and operations of the board be defined;
- strengthening corporate values and ethics practices; and
- improving the quality of reporting and disclosure.

At the time of writing this chapter, the Treasury Board Secretariat's review of Crown corporations' governance was still underway. The Secretariat informed us that it is considering these issues in its review.

The government has responded. The Treasury Board Secretariat states that the government remains committed to improving the governance of Crown corporations. The Treasury Board Secretariat also states that the current government's review of Crown corporation governance is examining many of the issues identified in the chapter and will address our recommendations.

Reaction from Crown corporation chairs and CEOs indicates that, for the most part, they agree with the recommendations directed specifically at them.

Introduction

7.6 Crown corporations are distinct legal entities that are wholly owned by the government. They deliver important public programs and operate in many sectors of the Canadian economy, including financial services, culture, transportation, agriculture and fisheries, energy and resources, and government services.

7.7 Crown corporations account for a significant portion of government activity. There are currently 43 federal Crown corporations (not including subsidiaries), employing 73,100 people. In aggregate (excluding the Bank of Canada), they manage $78 billion in assets. Parliamentary appropriations to Crown corporations amounted to $5.2 billion in 2003–04.

7.8 While Crown corporations represent a significant opportunity to achieve public policy and other goals and to generate revenue, they also represent significant exposure to potential financial losses and other risks. It is critical that Crown corporations, as public sector entities, be well governed if taxpayers' money is to be well managed.

7.9 Corporate governance refers to the process and structure for overseeing the direction and management of a corporation so that it carries out its mandate and objectives effectively.

7.10 The legislative framework for the governance and accountability of most federal Crown corporations is set out in Part X of the *Financial Administration Act* (FAA). For some "exempt" corporations where Parliament wanted to create further distance from the government, the governance and accountability regime is normally set out in their enabling legislation. In addition to these legislative requirements, governance principles and practices for Crown corporations are contained in various other documents such as governance policies, guidelines, and practices issued by the Treasury Board Secretariat and the Privy Council Office. Individual Crown corporations also establish their own internal policies and practices on governance.

7.11 The governance regimes attempt to balance the Crown corporation's relationship with the government—between the corporation's autonomy in day-to-day activities and the government's appropriate direction and control. The legislation places the board of directors at the centre of the governance regime for Crown corporations. Under this governance regime, the board oversees the management of each corporation and holds management responsible for its performance; it is responsible for establishing the corporation's strategic direction, safeguarding the corporation's resources, monitoring corporate performance, and reporting to the government and Parliament. The corporation is accountable to Parliament through a responsible minister.

7.12 Although the formal ownership structure varies among federal Crown corporations, in substance, the Government of Canada acts as the shareholder for federal Crown corporations and will be referred to as such in the remainder of this chapter. In practice, several individuals and organizations are involved in the discharge of the government's responsibilities in relation to Crown corporations:

- the Governor in Council
- the responsible minister, deputy minister, and department
- the Treasury Board and its Secretariat
- the Minister and Department of Finance Canada
- the Privy Council Office
- the Prime Minister's Office

7.13 Our audit in 2000 assessed how well three key aspects of corporate governance required by the *Financial Administration Act* were functioning in Crown corporations:

- the process of appointing directors, the board chair, and the chief executive officer (CEO);
- the composition, role, responsibilities, and performance of the board's audit committee; and
- the government's capacity to set and communicate performance expectations, review and challenge the corporation's corporate plan before approving it, and ensure that the Crown corporation's mandate continues to be relevant.

Important developments and initiatives since our 2000 audit

7.14 Following the recent corporate scandals in the United States and Canada, legislators and securities regulators in both countries have focussed on strengthening governance practices in publicly traded corporations. Considerable attention has been given to the need to set clear expectations for the performance of boards, audit committees, and management, and for the disclosure of information to various stakeholders. Legislation in the United States (*Sarbanes-Oxley Act*) and actions of securities regulators in Canada are turning these new expectations for good governance into requirements.

7.15 In February 2004, the President of the Treasury Board announced a series of reviews of government operations and management, including the *Financial Administration Act*, the governance of Crown corporations, and the accountabilities of ministers and senior public servants. Our Office has provided input to these reviews, including our perspective on the governance of Crown corporations and the accountability framework in Part X of the FAA, and our suggestions for improving them. At the end of our follow-up, the Treasury Board Secretariat had not yet completed its reports on these reviews.

7.16 Another significant development is the Commission of Inquiry into the Sponsorship Program and Advertising Activities (the Gomery Commission). The Commission's mandate includes examining the adequacy of the current accountability framework for Crown corporations. The Commission is still holding hearings and is currently scheduled to report in December 2005.

7.17 In February 2004, the government stated that "a transparent appointment system must be put in place to ensure that citizens have confidence that the best people to serve Canadians are being appointed to public institutions." In March 2004, the government announced important changes to the process for appointing directors, chairs, and CEOs of Crown corporations. At the time of writing the chapter, this revised process was still being implemented.

Focus of the follow-up

7.18 This chapter reports on the extent of the government's and Crown corporations' progress in addressing the recommendations from our 2000 Report and our 2002 audit observation on compensation to executives of Crown corporations.

7.19 In 2001, the House of Commons Standing Committee on Public Accounts held a hearing on our 2000 chapter; its report in early 2002 echoed many of our concerns and made 10 recommendations to the government. In Appendix A, we summarize the status of the government's actions to address each of the Committee's recommendations.

7.20 In this chapter we also discuss recent developments in the governance practices of publicly traded corporations and our views on their relevance to federal Crown corporations.

7.21 Further details on the objectives and scope of our follow-up audit are included in **About the Follow-Up**, at the end of the chapter.

Observations

Appointing directors, board chairs, and chief executive officers

7.22 In a "board-centered" model of governance, the board of directors is responsible for the affairs of the corporation. For good governance, it is essential that the process of selecting and appointing people to the board gives it the right combination of skills and abilities to carry out its mandate and responsibilities effectively.

7.23 Our audit in 2000 found that the government needed to strengthen its appointment process to address the following weaknesses:

- Crown corporations needed to define more clearly the skills and capabilities required on their boards, and the government needed to act on those requirements.
- Although board membership reflected Canada's diversity, it lacked some of the key skills and capabilities needed to oversee the corporation's affairs effectively.
- New directors were given orientation training but were not briefed adequately on their duties and responsibilities, the corporation's

relationship to the government, policies on the compensation of Crown corporation executives, and board procedures.

- Boards of directors were not engaged enough in the renewal of the board and the selection of its chair.
- Appointments to boards were not timely and directors' terms were unevenly staggered, a serious problem that undermined the continuity and stability of boards.

We also advocated a "board search" model for the selection of the chief executive officer, in which the board would play a key role.

Despite some improvements, weaknesses in the appointment process remain

7.24 In our follow-up audit, we reassessed the appointment process in place before the government announced the revised process in March 2004. We found a number of improvements; however, some key concerns we raised in 2000 had not been resolved.

7.25 Following our 2000 audit, the Privy Council Office (PCO) issued a guide to assist Crown corporations in preparing directors' profiles. It subsequently requested all Crown corporations to develop/update their profiles. We noted that most Crown corporation boards now have in place director profiles, most of which reflect the diversity of Canada and the skills and abilities needed to oversee the affairs of the corporation. The expected skills and abilities include, among others, financial and human resources expertise, industry-specific knowledge, and personal and other qualities. Boards use the profiles to identify gaps in the needed mix of skills and communicate in writing to responsible ministers and the PCO. There are now more directors who have the skills and abilities expected by board profiles, especially financial expertise and financial literacy.

7.26 In 2003, the PCO established an orientation course for new directors in response to our 2000 recommendation. The new course covers board procedures, compensation policies, the director's fiduciary responsibilities to the corporation, and the corporation's relationship to the government. The PCO informed us that, so far, 80 percent of Crown corporations have participated in the training program.

7.27 However, some key concerns we noted in 2000 had not been resolved. We noted difficulties in bringing people onto boards with the needed skills, abilities, and experience. It took one corporation two years, and repeated requests, to have the government appoint a member to its board with the proper financial expertise.

7.28 The *Financial Administration Act* requires the responsible minister to consult with the board prior to the appointment of a chair or CEO. However, we found that the government's consultation with boards on the selection of a chair had been uneven.

7.29 Crown corporations were still not making systematic use of a "board search" model to ensure that the board plays a key role in selecting a new CEO. A selection process that does not involve the board weakens the accountability relationship between the board and the CEO. If CEOs are not appointed or selected by the board, they may believe that they are accountable to the organization or individual that selected and appointed them. As discussed later in the chapter, the revised appointment process announced in March 2004 provides for board involvement in the appointment of chairs and CEOs.

Appointments are not timely, and terms are still not evenly staggered

7.30 The timeliness of appointments of directors, board chairs, and CEOs is still a major issue. In fact, the length of time that board members continue to serve after their terms as directors have expired has increased by 20 percent since we raised this concern in 2000. As shown in Exhibit 7.1, at September 2004, over one third (56) of directors (excluding CEOs, chairs, and directors from the public sector) of the 15 largest Crown corporations

Exhibit 7.1 Timeliness of appointments of directors to Crown corporations' boards

Number of terms expired and average time since expiration (15 largest Crown corporations*)

Fifteen largest Crown corporations	Number of directors (excluding CEOs, chairs, and directors from the public sector)	Number whose terms have expired	Average time since term expired, at September 2004 (days)
Atomic Energy of Canada Limited	15	5	199
Bank of Canada	12	2	397
Business Development Bank of Canada	11	5	420
Canada Deposit Insurance Corporation	5	2	250
Canada Mortgage and Housing Corporation	7	4	239
Canada Pension Plan Investment Board	11	5	340
Canada Post Corporation	9	1	112
Canadian Broadcasting Corporation	9	5	149
Export Development Canada	11	6	439
Farm Credit Canada	10	1	34
Marine Atlantic Inc.	11	0	N/A
National Capital Commission	14	5	322
Public Sector Pension Investment Board	9	4	187
Royal Canadian Mint	8	3	62
Via Rail Canada Inc.	13	8	135
Total	**155**	**56**	

*15 largest Crown corporations by number of employees, assets, and revenues

Source: Privy Council Office

were still sitting on boards while their terms had expired. In 9 corporations, the average length of time that directors had served since their term expired was more than six months.

7.31 At the time of writing this chapter, four major Crown corporations (Via Rail Canada Inc., Business Development Bank of Canada, Export Development Canada, and Canada Post Corporation) had CEOs who had been acting in the position temporarily, in some cases, for more than eight months. These four Crown corporations represent some of the largest corporations in Canada, managing assets totalling $37.3 billion and employing 51,000 people. In our view, these senior positions need to be filled by permanent CEOs on a high-priority basis.

7.32 Appointments to the board are still not staggered evenly, increasing the risk that continuity of expertise and corporate memory will be lost. For example, one Crown corporation was in the process of replacing or renewing the appointments of 8 of its 12 directors during 2004. In addition, we have identified 12 corporations in which the terms of the majority of their directors will expire in the same year. The *Financial Administration Act* sets the terms of directors of Crown corporations to up to three years. In our view, increasing this limit could facilitate the staggering of appointments.

The revised appointment process could improve Crown corporation governance

7.33 In March 2004, the government announced important changes to the process for appointing directors, chairs, and CEOs of Crown corporations. Following the announcement, the process was further refined. In April 2004, the President of the Treasury Board advised individual Crown corporations that their organization was required to follow this process in the future for appointment of the CEO, board of directors, and chairperson, unless the enabling legislation of their organization provided otherwise (see Appendix B).

7.34 At the time of writing this chapter, the government had appointed only a small number of new directors to boards of Crown corporations since the March announcement. In early October 2004, the Privy Council Office informed us that the revised appointment process was still being refined—for example, parliamentary committees were still looking at the positions that would be subject to their review. The Treasury Board Secretariat advised us that its review of Crown corporation governance will also address the appointment process.

7.35 In our view, the revised process has the potential to address many of the issues we raised in 2000. It reflects some of the best practices in Canada and in other jurisdictions. For example, boards of directors, through their nominating committees, would play a significant role in board renewal by screening and recommending suitable candidates for director positions; that should contribute to removing any remaining gaps in skills and abilities. In screening those candidates, the nominating committee will need to pay particular attention to their personal and other qualities, such as being independent-minded, that could have an impact on board dynamics and the board's effectiveness in challenging management.

7.36 There are only a few Crown corporations where the CEO is appointed by the board of directors. In most cases, CEOs are appointed by the Governor in Council. For the latter corporations, the revised process gives the board of directors a larger role than previously in identifying potential candidates for the CEO positions and recommending them to the minister. This is a significant step in enhancing the involvement of the board, although it differs from practices in the private sector. There, the board of directors is responsible for the selection, appointment, and termination of the CEO. In our view, having the board of directors play the lead role in selecting the CEO will contribute to enhancing his/her accountability to the board.

7.37 However, the problems of timeliness and staggering of appointments may not necessarily be corrected by the revised process. It will be important for the government to ensure that these issues are properly addressed.

7.38 The appointment process for senior executives of Crown corporations provides that some steps do not necessarily have to be followed. In our view, exceptions to the process need to be well supported and their rationale made public.

7.39 Although the revised process has the potential to improve Crown corporation governance, it will not be possible to assess its effectiveness until the process operates for some time.

The functioning of audit committees

7.40 The audit committee is a core committee of the corporation's board of directors and an essential part of good corporate governance. How it performs is an indication of how well the corporation's governance regime is functioning. In 2000, we looked at the performance of 14 Crown corporation audit committees. We compared their practices with about a dozen recognized best practices at the time in Canada and elsewhere to provide a basis for future self-assessment and to identify any potential for improvement in their performance.

7.41 We reported in 2000 that half of the 14 audit committees were ineffective or only marginally effective. As part of this follow-up, we returned to each of those committees to assess their progress against the same best practices we had used as benchmarks in 2000 (Appendix C sets out those practices).

Audit committees have improved their performance

7.42 Our follow-up audit found that Crown corporation audit committees are now following many of the best practices we identified in 2000 and have generally improved their performance.

7.43 Thirteen of the committees have charters or terms of references that reflect the best practices we identified in 2000. For example, the charters acknowledge key audit committee responsibilities such as overseeing the financial reporting process and the audit regime, and reporting to the full board of directors. We also noted a significant improvement in some committees' oversight of corporate risk management and the internal control environment. Operating procedures of 11 of the 14 audit committees include regular private meetings with the auditors and with management.

7.44 In general, audit committee members are financially literate. They now have stronger financial skills and abilities and consequently have been more effective in reviewing and challenging management's actions and proposals. Overall, we found that nine of the audit committees now fulfill their roles and responsibilities effectively; the five others are still marginally effective.

7.45 Still, there is room for further improvement in how audit committees function in a number of Crown corporations. We noted individual cases where, for example, the audit committee did not effectively challenge management. The quality of information provided to the audit committee could be improved (information could be more timely and complete). In some cases, the committee could better demonstrate how it fulfills its responsibility for overseeing the ethical practices of the corporation; this could be done through an annual review of management's compliance with the corporate code of conduct. Finally, some audit committees were still not playing an active role in soliciting information about significant risks and exposures and reviewing the adequacy of internal controls to manage those risks.

7.46 In October 2003, the Treasury Board Secretariat issued *Guidelines for Audit Committees*. These guidelines suggest best practices for audit committees of federal Crown corporations. They present practices to help individual audit committees improve their effectiveness. Boards of directors and audit committees are to tailor the guidelines to meet their specific needs. As mentioned later in this chapter, with expectations for audit committees continuing to increase, the guidelines need to be updated to show clearly what the government expects of effective audit committees.

Clarifying relationships and expectations with the shareholder

7.47 Establishing and following good governance practices provide assurance to the shareholder and stakeholders that the corporation is being managed in an appropriate way to achieve the expected results. Ensuring that the roles and responsibilities of all key parties in governance are clear, that performance expectations are set and understood, and that all parties are accountable for their performance contributes to the achievement of corporate objectives.

7.48 We reported in 2000 that the government had limited knowledge and expertise to challenge the corporate plans of Crown corporations. Our special examinations had identified weaknesses in the strategic planning of 66 percent of Crown corporations. Thus, the government was approving many deficient corporate plans.

7.49 We also noted that only two Crown corporations had been subject to mandatory and systematic mandate reviews. Other corporations carried out mandate reviews on a generally ad hoc basis, and many reviews did not engage the Treasury Board, the responsible minister, and Parliament or address all significant issues. Thus, we recommended that the government develop guidelines for conducting mandate reviews.

7.50 In 2000, we also found that the roles and responsibilities of key players in Crown corporation governance needed to be clarified. Further, we noted that no process of formal communication was in place between each Crown corporation and the responsible minister to provide for needed dialogue and consensus. In addition, we found that half of corporations that we examined rarely saw their minister.

7.51 We concluded that these weaknesses impeded the successful implementation of Part X of the *Financial Administration Act* (FAA) and affected the quality of Crown corporation governance. In our follow-up audit, we found little progress in addressing these issues.

Weaknesses remain in the review of corporate plans and mandate relevance

7.52 Feedback from the government on corporate plans is still limited. Neither the Treasury Board Secretariat nor the applicable departments have clearly defined their respective roles in the process for reviewing and approving corporate plans or assessed the capacity and skills needed to fulfill their roles.

7.53 Recent special examinations of Crown corporations continue to reveal weaknesses in corporate planning. Many Crown corporations still are not setting clear goals and indicators of performance for their public policy objectives. Some deficient corporate plans are still being approved.

7.54 Crown corporations that undergo mandate reviews are still the exception, and the reviews are still usually carried out on an ad hoc basis. There are still no guidelines for conducting mandate reviews. In Chapter 8 of our November 2004 Report to Parliament, we commented on Telefilm Canada; its corporate activities had changed but its mandate had not been amended to authorize the changes (Exhibit 7.2). Periodic and systematic

Exhibit 7.2 Telefilm Canada—Most of its activities are not consistent with its constituting legislation

The mission of Telefilm Canada, as stated in the *Telefilm Canada Act*, is to foster and promote the development of the feature film industry in Canada. Since the adoption of the Act in 1967, the activities of the Corporation have extended to the television, new media, and music sectors through memoranda of understanding and/or contribution agreements with the Department of Canadian Heritage. The majority of the Corporation's expenses are related to these new sectors of activity.

This expansion of Telefilm Canada's role and responsibilities in the development of the audiovisual and cultural industries has not been matched by an updating of its legislative mandate and powers—which today, 37 years after Telefilm Canada's creation, are still limited to developing the feature film industry. Parliament has not ratified the government's decision to extend Telefilm Canada's mandate to other sectors of activity. In our opinion, if the government intends to have Telefilm Canada support the development of the television, new media, and music industries, it is important that it bring forward the changes needed to modernize the Act. At the time of writing this chapter, the government had just tabled Bill C-18 in the House of Commons to update Telefilm's mandate. The Bill was referred to the Standing Committee on Canadian Heritage for review.

mandate reviews would help Parliament and the board ensure that the corporation's mandate is relevant to the government's policy objectives and the corporation's operating environment.

Relationships and accountability still need to be clarified

7.55 As mentioned previously, the *Financial Administration Act* places the board of directors at the centre of the governance regime for Crown corporations. The government retains power and influence over Crown corporations in areas such as appointment and remuneration of directors, chairs, and chief executive officers; directives and regulations; and approval of corporate plans and budgets. While the government's authority for Crown corporations rests with the responsible minister, in practice several players are involved in these areas.

7.56 Over the years, we have found that various representatives of the government do not always speak with one voice. While Part X of the FAA indicates that Crown corporations are accountable to Parliament through the responsible minister, it is not always clear what ministerial responsibility for a Crown corporation means in practice. The Gomery Commission and the Treasury Board Secretariat's reviews have mandates to explore this issue. Clarifying the corporation's relationship to the government and who speaks for the shareholder are essential for good corporate governance of all Crown corporations, including those exempt from Part X of the FAA.

7.57 Our 2000 chapter raised concerns about the role played by senior public servants appointed to the boards of some Crown corporations. In our view, representatives of the government, such as deputy ministers, can too easily be viewed as having a "super voice" and thereby unduly affect the direction of the board. Boards require access to public sector decision makers but not necessarily as members of the board.

7.58 In recent special examinations, we noted a lack of clarity among board members about the role of directors from the public sector. At times, board members deferred to them because they were considered to speak for the government. While directors from the public sector may have the knowledge and expertise to help other board members appreciate the government's position on certain issues, their function is not to convey direction from the minister to the board. They have the same statutory obligations as any other director: to exercise independent judgment in ways that best fulfill their responsibility to the corporation. Having the fiduciary responsibility to act in the best interest of the corporation and owing loyalty to their minister can place them in difficult situations at times. In our view, it is important to reassess the merits of having public sector directors on boards.

Communicating expectations—governance protocols between ministers and Crown corporations

7.59 There is still no formal process for setting out high-level expectations of the responsible minister before the corporate plan is developed. In practice, the relationship between boards of directors and responsible ministers varies—some meet regularly; others do not. A process to ensure that expectations are clear could help the board and the minister establish a mutual understanding of the corporation's mandate, the related performance expectations, public policy issues, and the shareholder's strategic priorities. This would be useful to the board in establishing the corporation's strategic direction and developing the corporate plan.

7.60 In other jurisdictions, there have been some efforts to clarify and publicly disclose shareholders' policy objectives and expectations. For example, the government of British Columbia now has a governance structure designed to clarify the relationship between the Province and provincial Crown corporations (Exhibit 7.3). We understand that communication between the responsible ministers and the corporations has improved. Such a governance structure should help to clarify the relationship between the corporation and the responsible minister and should ensure that the government speaks transparently and with "one voice."

Exhibit 7.3 A process used to clarify expectations between the government and a Crown corporation

In the British Columbia model, the minister responsible for the Crown corporation, as the representative of the government, communicates broad strategic direction and expectations as determined by the Cabinet. This direction and formal expectations for the Corporation are communicated annually in a "letter of expectations" that is also signed by the Crown corporation board's chair and made public. This letter also identifies actions the government will take to assist the Crown corporation in achieving mandate and operational objectives. The minister responsible for the corporation is the voice of the government. By playing a role in establishing the corporation's direction and the government's expectations of it, the minister is reflecting the expectations of the owner and there is a basis for accountability for the corporation's actions. In this model, the minister does not take over the role of the board but communicates formally and publicly the performance that the government expects from the corporation. The board is responsible for governing the corporation within that framework.

Source: Office of the Premier, Province of British Columbia

7.61 A clear role for the minister in establishing and communicating formal, high-level expectations of the corporation would also help ensure the continued relevance of a Crown corporation's mandate. Special considerations may need to be taken into account for Crown corporations that are presently exempt from Part X of the *Financial Administration Act*.

Disclosure of executive compensation

7.62 In December 2002, we reported the need for improved transparency of senior executives' salaries and other compensation. In the two years since our audit observation, very little has happened. Only a few federal Crown corporations disclose some information on executive compensation. Corporations listed on stock exchanges are required to disclose the total compensation (including remuneration and benefits) of senior executives and board members. These practices reinforce that a best practice is for boards and executives to disclose such information.

Implications of Recent Developments in Corporate Governance

New Canadian expectations

7.63 As mentioned earlier in the chapter, the recent corporate scandals in the United States and Canada have led legislators and securities regulators in both countries to strengthen their requirements for the governance practices of publicly traded corporations. In the United States, these requirements were set out in the *Sarbanes-Oxley Act* of 2002. In Canada, securities regulators have proposed expected best practices in National Policy 58-201, which are similar to those in the United States. These proposals now set clear expectations for the performance of boards of directors, audit committees, and management, and for the disclosure of information to various stakeholders.

7.64 Although Crown corporations are not subject to these proposed requirements, we believe that many of the principles underlying them are relevant to the public sector environment and key aspects of them would strengthen the governance practices of Crown corporations and their accountability to Parliament. As part of our ongoing audit work in Crown corporations, we noted the significant efforts of some in the last two years to review and improve their own internal governance policies and practices. Some have already addressed these proposals or are in the process of doing so.

Strengthening the board

7.65 **Composition of the board.** Securities regulators in Canada now recommend that the majority of board members be independent, that the independent members hold regular meetings without management in attendance, and that the board chair be an independent director (that is, the chair and CEO positions should be separate).

7.66 These best practices are not always adopted in Crown corporations. We noted that the practice of holding board meetings without management in attendance is uneven. Further, in a few Crown corporations, the same individual acts as chair and CEO. Finally, as mentioned in paragraphs 7.57 and 7.58, the presence of directors from the public sector on a board of a Crown corporation needs to be reassessed.

7.67 **Board mandate.** Securities regulators propose that a board adopt a formal mandate in which it assumes its stewardship responsibility, including its responsibility to

- satisfy itself of the integrity of the CEO and other senior officers and their promotion of a culture of integrity;
- adopt a strategic planning process and approve at least annually a strategic plan that takes into account opportunities and risks of the corporation;
- identify principal risks of the business and ensure that appropriate systems are put in place to manage those risks;
- plan for succession;

- ensure the integrity of internal control and management information systems; and
- develop an approach to corporate governance that includes governance principles and guidelines specific to the corporation.

7.68 Board mandates will need to set out decisions that require prior approval by the board, measures for receiving feedback from security holders (in the case of a Crown corporation, the shareholder), and the board's expectations of management.

7.69 In our view, all these responsibilities are consistent with expectations for Crown corporations, including those established in the *Financial Administration Act*. Section 131 (2) of the FAA requires boards of Crown corporations to have reasonable assurance that the systems and practices of the corporation safeguard and control the corporation's assets; that the financial, human, and physical resources of the corporation are managed economically and efficiently; and that the operations of the corporation are carried out effectively. As Crown corporations update their board mandates, they should ensure that these requirements, as well as those established in the FAA, are taken into account.

7.70 **Orientation and continuing education.** Regulators propose that all new directors receive a comprehensive orientation and that the board provides opportunities for continuing education to all board members. We have already noted that the federal government recently developed an orientation course for directors of Crown corporations. However, much remains to be done by the government and the Crown corporations in providing continuing education. It is important to put the mechanisms in place to ensure that directors have access to continuing education programs in areas such as public sector developments, governance practices, financial literacy, and risks management.

7.71 **Code of business conduct and ethics.** Boards in publicly traded companies will be required to adopt a written code of business conduct and ethics that is applicable to directors, officers, and employees. The code is to address such issues as conflict of interest; protection and proper use of corporate assets and opportunities; fair dealing with customers, suppliers, competitors, and employees; confidentiality of corporate information; compliance with laws, rules, and regulations; and reporting of any illegal or unethical behaviour. The board will be responsible for monitoring compliance with the code and ensuring that the corporation's ethical standards and values are observed and that the corporation discloses how fully they are observed.

7.72 In our view, the need for boards to establish and monitor values and ethics codes is equally important in Crown corporations as in publicly traded companies. In addition to business ethics, Crown corporations need to reflect values such as serving the public interest. Although our follow-up work did not cover this issue, we noted in our other audit work that many Crown corporations are now reviewing their values and ethics programs and infrastructure. A number of others have already implemented some of the best practices in that area.

7.73 As Crown corporations review their values and ethics programs, they need to reflect both private sector expectations and the principles underpinning the new *Values and Ethics Code for the Public Service*. The government has asked all public service institutions not covered by the Code, including Crown corporations, to respect the Code's spirit and adopt similar provisions for their organizations. A related document is the *Conflict of Interest and Post-Employment Code for Public Office Holders*. This Code applies to order-in-council appointees such as directors, chairs, and CEOs of Crown corporations. Exhibit 7.4 summarizes the key principles of this conflict of interest code.

7.74 In our view, the development and implementation of codes of conduct and ethics are essential elements of good governance. We intend to examine this area in the future, given that many Crown corporations are currently reviewing their ethics and values programs and infrastructure.

7.75 **Regular board assessments.** Boards and board committees of publicly traded companies will be expected to assess their collective effectiveness as well as the effectiveness and contribution of each board member. The assessment is to consider the board's written mandate, the charter of each board committee, and the competencies and skills each director is expected to bring to the board. As noted in our 2000 Report, we support board assessments as a best practice that should be implemented in Crown corporations. Such assessments could help boards identify opportunities to improve their practices or identify skills and abilities that need to be added to the board or its committees.

7.76 In our recent special examinations of Crown corporations, we noted that a number of boards are assessing the board's collective effectiveness and its committees. However, we also noted the need for more effort in assessing the contributions of individual board members. This is important if boards are to improve their effectiveness and fulfill their responsibility for renewal.

7.77 **Director compensation.** In the private sector, the roles and responsibilities of boards of directors—and, more specifically, audit committees—have increased significantly in the last few years. This has resulted in a greater demand for highly qualified people. A recent study reported that, in 2001, compensation to directors in the private sector averaged about $19,000 in annual retainer fees and $1,300 for attending each board meeting. Current literature shows that these fees are significantly higher today, reflecting the increased responsibility and accountability of board directors.

7.78 In Crown corporations, the recommended annual retainer fee ranges from $2,600 to $10,300, and fees for attending board meetings are between $160 and $800. These compensation levels have not changed in the last four years. Chairs and CEOs of Crown corporations have said that compensation has not kept up with the increase in workload and responsibilities. In our view, as the government decides to increase responsibilities of boards of directors, it may want to review the compensation paid to directors in order to confirm its appropriateness in attracting and keeping those who are best qualified.

Exhibit 7.4 Values and ethics for public office holders—key principles

Ethical standards	Public office holders shall act with honesty and uphold the highest ethical standards so that public confidence and trust in the integrity, objectivity, and impartiality of government are conserved and enhanced.
Public scrutiny	Public office holders have an obligation to perform their official duties and arrange their private affairs in a manner that will bear the closest public scrutiny, an obligation that is not fully discharged by simply acting within the law.
Decision making	Public office holders, in fulfilling their official duties and responsibilities, shall make decisions in the public interest and with regard to the merits of each case.
Private interests	Public office holders shall not have private interests, other than those permitted pursuant to this code, that would be affected particularly or significantly by government actions in which they participate.
Public interest	On appointment to office, and thereafter, public office holders shall arrange their private affairs in a manner that will prevent real, potential, or apparent conflicts of interest from arising, but if such a conflict does arise between the private interests of a public office holder and the official duties and responsibilities of that public office holder, the conflict shall be resolved in favour of the public interest.
Gifts and benefits	Public office holders shall not solicit or accept transfers of economic benefit, other than incidental gifts, customary hospitality, or other benefits of nominal value, unless the transfer is pursuant to an enforceable contract or property right of the public office holder.
Preferential treatment	Public office holders shall not step out of their official roles to assist private entities or persons where this would result in preferential treatment to any person.
Insider information	Public office holders shall not knowingly take advantage of, or benefit from, information that is obtained in the course of their official duties and responsibilities and that is not generally available to the public.
Government property	Public office holders shall not directly or indirectly use, or allow the use of, government property of any kind, including property leased to the government, for anything other than officially approved activities.
Post-employment	Public office holders shall not act, after they leave public office, in such a manner as to take improper advantage of their previous office.
Fundraising	Public office holders are not to personally solicit funds from any person, group, organization, or corporation where such fundraising could place public office holders in a position of obligation incompatible with their public duties.

Source: Privy Council Office

Strengthening the audit committee

7.79 As the audit committee is the board committee responsible for oversight of financial controls and disclosure, regulators' and stakeholders' expectations of the audit committee have increased in the last few years, and so has the committee's role.

7.80 Canadian securities regulators recently issued, in multilateral instrument 52-110, requirements for practices that audit committees of publicly traded companies are to follow. These requirements are generally consistent with the best practices we identified for Crown corporations in 2000. However, in a few areas, they go beyond what is expected from audit committees of Crown corporations.

7.81 **Independence.** All members of audit committees are now expected to be independent. This goes well beyond the governance regime of Crown corporations: the *Financial Administration Act* currently requires only that the majority of audit committee members not be members of management or employees of the corporation. Regulators have defined independence for audit committees generally to mean no direct or indirect material relationship with the company. Those prohibited from sitting on the audit committee are current or recent employees or executives of the company, family members of current or recent executives, and partners or employees of the external or internal auditor (or auditors who recently filled the positions). There are also restrictions on compensation for services other than acting as a member of the board.

7.82 Most Crown corporation audit committees have a membership that reflects these expectations. In our view, however, the full independence of audit committees needs to be clearly required in policy or in legislation.

7.83 **Approval of financial disclosure.** Regulators require audit committees to review financial statements, and the management discussions and analysis associated with the statements, before their release. Audit committees must also ensure that adequate procedures are in place for the review of any other financial information to be released by the corporation. Further, audit committees are expected to establish procedures for dealing with complaints or concerns, including those made anonymously, about accounting, internal accounting controls, and audit matters.

7.84 We noted that the audit committees of Crown corporations review, discuss, and approve annual financial statements. However, the review of other key information being disclosed in the annual report or in other public documents is uneven and usually less rigorous. As the demand for better reporting and disclosure increases, these requirements will become increasingly important for audit committees.

7.85 **Handling complaints and concerns**. Finally, the introduction of "whistle-blowing" mechanisms in Crown corporations is still at an early stage. Currently, some audit committees have implemented, or are considering implementing, procedures to handle complaints or concerns from interested parties. The government has introduced legislation in the House of

Commons pertaining to "whistle blowing" in the public service, which will also apply to Crown corporations.

Strengthening expectations of management

7.86 While recent developments in corporate governance have focussed on the board, more is expected of management in a number of areas. In particular, legislators and regulators in the United States and Canada have been requiring management of publicly traded corporations to take personal responsibility for financial disclosure and for the internal controls of the organization. This responsibility is in the form of a public certificate that must be supported by evidence that controls are properly designed and working effectively. Regulators in Canada are currently considering if there is a need for the certificate to be supported by the attestation of the external auditor.

7.87 However, the Crown corporation environment has not experienced the same financial reporting issues that led regulators to require public certification in publicly traded companies. Therefore, we are not presently suggesting that a similar requirement be applied to Crown corporations. Current literature on this subject shows that the cost of implementing a certification process is significant. It is important that any consideration by the government to introduce a similar requirement for Crown corporations include an assessment of the costs and potential benefits of such a measure. Any certification requirement also needs to be tailored to the public sector environment.

Disclosure and reporting—closing the accountability cycle

7.88 We did not examine disclosure and reporting in our 2000 audit of governance in Crown corporations. However, in previous audits and studies we have noted repeatedly that Crown corporations need to improve the quality, timeliness, and completeness of the accountability information in their annual reports.

7.89 In the private sector, expectations for transparency and disclosure of financial and non-financial information have risen significantly for publicly traded companies. In the public sector, there have also been a number of initiatives to enhance public disclosure. Many of these developments could be adapted for federal Crown corporations to improve their disclosure practices.

7.90 Disclosure requirements of publicly traded companies have generally been more rigorous than those required of private companies or public sector corporations. Securities regulators in Canada and the United States have emphasized that managers of publicly traded companies must take more personal responsibility for the financial and non-financial information that they produce and disseminate.

7.91 **Management discussion and analysis of performance.** As part of the regulatory disclosure requirements, all companies are to include in their annual reports a management discussion and analysis (MD&A) of the company's financial condition, the results of its operations, and its cash flows. The analysis must include a comparison with the company's performance of the previous year. Regulators also require publicly traded companies to disclose their business risks and their key environmental and social policies.

7.92 The purpose of the MD&A is to give users of the financial statements the underlying information on, and reasons for, the reported performance and allow them to understand future trends. Recent guidance by the Canadian Performance Reporting Board of the Canadian Institute of Chartered Accountants (CICA) on MD&A describes accepted practice for these types of disclosure. While its guidance was written primarily for companies that are subject to oversight by securities regulators, the CICA indicated that public sector and non-profit organizations could also use it.

7.93 **Reporting on performance against public policy objectives.** Crown corporations have public policy objectives in addition to any commercial objectives. In our review of Crown corporations' annual reports for the Auditor General's Award for Excellence in Annual Reporting, we have found consistently that many Crown corporations fail to state their public policy objectives and evaluate their performance against them. For example, in 2003 we found that more than half of the Crown corporations did not report how they had performed in meeting their public policy objectives. With the recent guidance from the CICA on MD&A, we expect that analysis of the factors contributing to the achievement of commercial and public policy objectives will improve.

7.94 **Expanding access to information.** Presently, 28 Crown corporations are subject to the *Access to information Act*. The government's Access to Information Review Task Force in 2002 made a number of recommendations that could affect Crown corporations. In particular, the Task Force recommended that criteria be established to determine which institutions should be covered by the *Access to Information Act*. One set of suggested criteria would have the Act apply to any institution that has a majority of board members appointed by the government, receives all its financing through appropriations, or has its controlling interest owned by the government. Another suggested criterion would include institutions that perform functions in an area of federal jurisdiction related to health and safety, the environment, or economic security. The Task Force recommended that exceptions to these criteria be allowed where access to information would be incompatible with the institution's structure or mandate. We understand that the Treasury Board Secretariat's review of Crown corporation governance will address this issue.

7.95 **Making special examination reports public.** With some exceptions, Crown corporations are required to have a special examination conducted at least once every five years. In March 2004, the government announced its intention to have the reports on these examinations made public and tabled in Parliament. However, there is currently no formal requirement to do so. We have issued eight special examination reports since the government announcement in March. At the time of writing this chapter, four Crown corporations had posted their examination reports on their Web sites. In our view, the tabling of special examination reports in Parliament would assist parliamentarians in their oversight role for Crown corporation activities and performance. The Treasury Board Secretariat's review of Crown corporation governance is also addressing this matter.

7.96 Corporations in both the private and public sectors are being required to improve the quality and increase the quantity of public disclosure. Improved reporting in annual reports and other forms of public disclosure are expected by regulators and required from other public sector entities. These will help to ensure the transparency of operations and help stakeholders hold boards and management to account.

Conclusion and Recommendations

7.97 Overall, progress in addressing the recommendations from our 2000 audit of Crown corporation governance has been unsatisfactory. Individual Crown corporations have strengthened their own governance structures and practices. However, improvements that we recommended to strengthen the overall governance and accountability framework have not progressed as quickly and as far as we had expected.

7.98 Still, we found fewer gaps in the collective skills and expertise of board members. We also found that the composition and operating practices of board audit committees had improved and that audit committees are operating more effectively than in 2000.

7.99 Indications that governance practices have either not improved or improved slowly include the following:

- Only in 2004 did the government start addressing some of our key 2000 recommendations.
- A revised process for appointing Crown corporation boards of directors, chairs, and chief executive officers (CEO) was announced in March 2004 but has not yet been fully defined and implemented.
- It takes too long to appoint board members, chairs, and CEOs. Many board members' terms have expired. Some large Crown corporations are without permanent CEOs.
- The terms of board members are not evenly staggered, increasing the risk that corporate memory will be lost.
- The government has still not assessed the skills and abilities that it needs to review corporate plans and ensure the continued relevance of Crown corporation mandates.
- The responsibilities and expectations of the government regarding Crown corporations still need to be clarified.

7.100 Our recommendations from 2000 to improve the governance of Crown corporations continue to be relevant and valid today, and our review of practices outside the government shows that expectations continue to increase.

7.101 **Recommendation.** As the government establishes new expectations for good governance practices for Crown corporations, it should

- clarify the relationship between the board and the responsible minister and other representatives of the government;
- ensure that the government's expectations of the corporation are formally, clearly, and publicly communicated;
- effectively implement the revised appointment process for directors, chairs, and chief executive officers, paying particular attention to the timeliness and proper staggering of appointments;
- update current governance structures and practices to reflect best practices for the composition, roles, and responsibilities of boards and audit committees, including
  - reassessing the appropriateness of having public sector directors on boards,
  - reassessing independence requirements for members of audit committees, and
  - assessing the costs/benefits of implementing a certification process for internal control; and
- update current expectations for disclosure, reporting, and transparency to reflect best practices in private and public sectors.

7.102 **Recommendation.** In updating their board mandates and governance structures and practices to reflect best practices, boards of directors should

- ensure that directors have access to continuing education;
- develop/review their values and ethics programs and infrastructure to reflect the principles underpinning the new *Values and Ethics Code for the Public Service*;
- ensure that they assess their collective effectiveness as well as the contribution of each member;
- ensure that audit committees review and recommend to the board information that will be disclosed in annual reports and other public documents; and
- ensure that mechanisms are put in place to deal with complaints and concerns from interested parties.

Government's response. The government remains committed to improving the governance of Crown corporations. Many of the issues identified in this report are being examined in the context of the government's review of Crown corporation governance. We believe that the review will respond to the measures recommended in your report.

Crown corporations' responses. It is not practical to obtain the responses of 43 Crown corporations to the recommendations that apply to them directly. However, we did discuss our findings and recommendations with the chairs and/or CEOs of seven Crown corporations. Generally, they supported the main messages of the chapter and agreed with the recommendations directed specifically at Crown corporations.

About the Follow-Up

Objectives

The objectives of this follow-up were to assess the extent of the action taken by the government and Crown corporations to address our recommendations in our December 2000 Report, Chapter 18, Governance of Crown Corporations, and the December 2002 audit observation on executive compensation. We also wanted to determine the potential implications of recent developments in corporate governance on the governance and accountability framework of Crown corporations.

Scope and approach

Our follow-up work focussed on the main issues raised in our December 2000 Report and the related 2002 report of the House of Commons Standing Committee on Public Accounts and in our December 2002 audit observations.

We reviewed current developments in corporate governance in Canada and elsewhere. Based on our Office's past and current work on Crown corporations, we assessed whether changes were needed to strengthen the legislative framework for Crown corporation governance and accountability, and reflect current best practices in Canada and elsewhere.

We reviewed the process for appointing board members and the effectiveness of audit committees in 14 Crown corporations. We also interviewed staff at the Privy Council Office, Treasury Board Secretariat, and in federal departments. We interviewed chief executive officers (CEO), board and audit committee chairs, and corporate secretaries; reviewed files and management reports; and analyzed data. Finally, given that the Auditor General is the statutory auditor of most Crown corporations, we used a combination of document review and our own observations to assess the effectiveness of audit committees.

Criteria

We expected that the Government of Canada would have made satisfactory progress in addressing our recommendations. We used the audit criteria we had used in 2000, which are still relevant. That is, we expected that to protect the shareholder's interest, to ensure that Crown corporations achieve their public policy objectives effectively and efficiently, and to optimize their commercial objectives,

- there should be timely appointments of qualified board chairs, CEOs, and board directors that meet the requirements of the government and the corporation and that strengthen the accountability relationships among the board, the CEO, and the government;
- audit committees should be constituted with appropriate skills and experience, carry out necessary roles and responsibilities, and perform their duties effectively, as measured against best practices;
- the government should conduct a robust review and challenge of a corporation's corporate plan as the basis for the plan's approval; and
- there should be assurance that the mandate of each corporation, including its public policy and financial objectives, continues to be relevant.

Audit team

Assistant Auditor General: Richard Flageole
Director: Régent Chouinard

Arti Sachdev
Isabelle Dupuis

For information, please contact Communications at (613) 995-3708 or 1-888-761-5953 (toll-free).

Appendix A Status of the government's action to address recommendations made by the Public Accounts Committee in its Report on Chapter 18 of the December 2000 Report of the Auditor General of Canada

Recommendation	Status
That Treasury Board Secretariat (TBS) assess departmental capacity to review and challenge corporate plans of their respective Crown corporations. Once the assessment is completed, that a report be prepared identifying the areas where departmental review capacity needs strengthening, describing the initiatives required to upgrade departmental systems and practices, together with a timetable for implementation.	Assessment not completed by TBS and no report produced (see paragraph 7.52).
That Treasury Board Secretariat, when receiving the corporate plan for review and recommendation, request from the Crown corporation a copy of the most recent special examination report.	Special examination report to be available on Crown corporation Web site (see paragraph 7.95).
That Treasury Board Secretariat and the Department of Finance execute an assessment of their own capacity to review and challenge corporate plans. Once the assessment is completed, that a report be prepared identifying the areas where review capacity needs strengthening, describing the initiatives required to upgrade systems and practices, together with a timetable for implementation.	Assessment not completed by TBS and Department of Finance; no report produced (see paragraph 7.52).
That each Crown corporation review and amend its selection criteria and procedures for establishing the membership of its audit committee in order to ensure that all its members are financially literate and further ensure that at least one member possesses the required knowledge and experience in financial management and accounting.	Implemented (see paragraphs 7.43 and 7.44).
That the Privy Council Office provide assistance to Crown corporations in developing board skills profiles and ensure that these profiles are submitted in timely fashion to the responsible minister and the Prime Minister's Office.	Implemented (see paragraph 7.25).
That the government and the responsible ministers of Crown corporations take into consideration the skills profiles of candidates when selecting and appointing board chairs and directors.	Some progress, at March 2004 (see paragraphs 7.17, 7.25, and 7.27). Revised appointment process being implemented (see paragraphs 7.33 to 7.38).
That the government consider developing a formal mechanism or process that would permit a systematic review of a Crown corporation's mandate, executed on a ten-year basis or when significant changes to government policy or to the economic environment occur that impact on the relevance of the Crown corporation's mandate.	Not implemented (see paragraph 7.54).
That the government review and amend the process of appointing directors and chief executive officers (CEOs) to Crown corporations in order to ensure greater involvement of the Crown corporation's board of directors in recommending potential candidates to the Governor in Council.	Revised process being implemented (see paragraphs 7.33 to 7.38).
That the government prepare a transitional strategy that would allow certain Crown corporation boards the opportunity to build up the required capacity to conduct effective candidate searches for recommendation to the Governor in Council.	Revised process being implemented (see paragraphs 7.33 to 7.38).
That the government evaluate the practicality of applying best practices found in other countries or jurisdictions for appointing senior officers to public sector or government-owned corporations. That the government prepare a report containing recommendations based on the best practices.	Completed; report prepared by the Privy Council Office. Revised process being implemented (see paragraphs 7.33 to 7.38).

Appendix B Appointment process for senior executives of Crown corporations

Nominating committee

The board of directors must establish a nominating committee to identify candidates for the positions of CEO, chairperson, and directors. This committee may include outside eminent persons. In undertaking its work, the nominating committee will need to rely on rigorous processes involving the use of a professional recruitment firm, where appropriate, as well as public advertisements for the selection of the CEO and chairperson. In particular, it will have to develop selection criteria for the CEO and chairperson, as well as a competency profile for the board as a whole. In the case of the CEO and chairperson, the positions would normally be advertised in the *Canada Gazette* and national newspapers. For all positions, including those of directors, the nominating committee will normally seek the assistance of an executive search firm.

Selection criteria for CEO and chairperson

The selection criteria for the CEO and chairperson should consist of the following elements: education, experience, knowledge, abilities, and personal suitability required for the position. Abilities could include characteristics such as corporate vision, leadership, and the ability to communicate effectively with stakeholders. Personal suitability could include attributes such as ethical character and sound judgment.

Board competency profile

For directors, a board competency profile should be developed. This is a description of the experience, attributes, and skills that should be possessed by the board as a whole. This profile will be based on the roles and responsibilities of the board, and may include a set of generic attributes that all board members must have, such as adaptability, sound judgment, collegiality, and financial acumen, as well as specific attributes such as knowledge of the industry. The profile should also recognize the need for the board to be representative of the Canadian population and of Canada's geographic regions. Additional information on how to build a director's competency profile can be found on the Privy Council Office Web site.

Director's skills profile

In filling a director's position, the nominating committee will want to assess the skills of those already on the board. Having done this, and taking into consideration the board profile, the committee can identify the specific competencies required to complete the skills mix for the board as a whole.

Agreement on selection criteria and board profile

Once selection criteria and board competency profiles have been completed, these will need to be discussed with the responsible minister's office, the director of appointments in the Prime Minister's Office, and the Senior Personnel and Special Projects Secretariat of the Privy Council Office.

Responsible minister's review of candidate list

Once a list of suitable candidates for the positions of CEO, chairperson, and director has been developed by the nominating committee using the approach above, it will be submitted to the board of directors, who will provide a short list of candidates to the minister responsible for the corporation. Based on this list, the minister will make a recommendation for appointment. The appropriate parliamentary committee may then review the candidate recommended by the minister.

Re-appointments

In the case of re-appointments, the nominating committee will want to assure itself that the individual has the competencies required for the position. This being the case, the name of this individual will be submitted to the responsible minister who will make a recommendation for re-appointment. The appropriate parliamentary committee may then review the candidate recommended by the minister.

Additional information

Additional information on these processes can be obtained from the Senior Personnel and Special Projects Secretariat of the Privy Council Office, which will also be responsible for the placement of advertisements in the *Canada Gazette*.

Source: The Treasury Board of Canada

Appendix C Selected best practices for audit committees

Best practices since 2000 are highlighted in blue

The audit committee should ensure financial oversight by

- critically reviewing the interim and annual financial statements, the auditor's report, and the management discussion and analysis section of the annual report;
- ensuring that presentation of financial statements is fair, appropriate, and clear, and that it meets generally accepted accounting principles; and
- actively soliciting the external auditor's judgments about the acceptability and the quality of the corporation's accounting principles as applied in its financial reporting. This discussion should include such issues as the clarity of financial disclosure and the aggressiveness or conservatism of the corporation's accounting principles and estimates.

The audit committee should ensure oversight of corporate books, records, financial and management control and information systems, and management practices by

- reviewing the special examination plan and report prepared by the external examiner;
- actively soliciting information about significant risks and exposures and reviewing the adequacy of internal controls to manage those risks;
- reviewing the integrity and effectiveness of the management information systems;
- reviewing internal audit plans and reports and management's subsequent actions; and
- reviewing significant findings and recommendations made by the external auditor and examiner and following up on management's subsequent actions.

The audit committee should

- ensure ethical oversight through the annual review of management's compliance with the corporate code of conduct;
- actively solicit all sensitive information (for example, senior management expenses, significant litigation, non-compliance with laws and regulations, misuse of corporate assets, illegal activities);
- oversee the resolution and investigation of complaints of wrongdoing (audit committee mandates should include the requirement for a process to investigate and resolve all complaints, including those made anonymously);
- ensure that internal audit is adequately resourced and that it has adequately covered the major risks and activities of the corporation; and
- recommend external auditors and their compensation, and pre-approve all non-audit services by external auditors to ensure that their objectivity and independence are preserved.

Membership and competencies

- Audit committees should be composed of at least three members. Each member should be an independent director, who should not be an officer or an employee of the corporation.
- Although a variety of skills and experience is beneficial to an effective and balanced audit committee, all members should be financially literate and at least one member should have accounting or related financial management expertise. Financial "literacy" signifies the ability to read and understand fundamental financial statements, including a balance sheet, income statement and cash flow statement, and the ability to ask probing questions about the corporation's financial risks and accounting. "Expertise" signifies past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual's financial sophistication (experience as a chief executive officer, for example, or other senior officer with financial oversight responsibilities).

Operating procedures

Terms of reference. Audit committees should have clear, written terms of reference and operating procedures that specify the scope of the committee's responsibilities and how it carries them out, including its structure, processes, and membership requirements.

Meetings. The frequency of audit committee meetings should be tailored to the responsibilities assigned, but should be at least quarterly. The audit committee should also meet periodically with management, the external auditor, and the head of internal audit, in separate private sessions.

Disclosure requirements

Audit committees should publicly disclose their charter, composition, recommendations not adopted by the board, and nature and amounts of auditor's fees, in audit and non-audit services.

Chapter

8

Managing Government Financial Information

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Managing Government
Financial Information

Main Points

8.1 The government has taken some positive steps in response to our previous recommendations but, overall, we find that its progress on the use of improved financial information in departments and agencies, and improvements in its financial information systems supporting that information, continues to be very slow and, thus, unsatisfactory. However, with a commitment to strengthen financial management and control provided in recent announcements, we are optimistic that the necessary financial leadership and capacity will be developed to significantly advance our previous recommendations.

8.2 Success in these efforts will require continued leadership and commitment. With the Office of the Comptroller General of Canada re-established, the newly appointed Comptroller General can now champion this initiative by aggressively advancing the use and timely preparation of accrual financial information, promoting the importance of good financial internal controls, and working to strengthen the comptrollership capacity in departments and agencies. In addition, deputy ministers and senior department and agency financial officials also need to play a critical role in improving the use of accrual financial information and financial internal control systems.

8.3 Integrated and comprehensive internal financial control systems play a significant role in ensuring that high-quality financial information is available for decision making and financial reporting. They should be given a high priority within departments and agencies. However, weaknesses we previously reported in these systems persist, and departments and agencies have been slow to correct them. Departments and agencies must step up their efforts to correct weaknesses in their internal financial control processes.

8.4 The government must also finalize its study of accrual-based budgeting and appropriations at the department level and implement an approach for a common basis of planning, budgeting, and reporting. After several years of examining this issue, it is now time to prepare a way forward. Without definitive direction and guidance on this issue, wider use of improved financial information in decision making will be impeded.

8.5 Finally, the Office of the Comptroller General must resolve all remaining issues regarding the fair presentation of departmental and agency financial statements so that the government can achieve its objective of having all such financial statements audited within five years. Some progress has been made in addressing these issues, but more work is required.

The Treasury Board Secretariat has responded. The Treasury Board of Canada Secretariat agrees with the recommendations, and the responses in the chapter describe current or planned actions to address the recommendations.

The Treasury Board Secretariat is also pleased that the Auditor General has recognized the positive steps that have been taken in response to previous recommendations. It is confident that recent measures taken to strengthen financial management and control will provide a solid foundation for the future.

The reinstatement of the Office of the Comptroller General along with the appointment of a new Comptroller General and professionally accredited departmental comptrollers will bring renewed focus to those areas where progress is needed.

Introduction

Why is financial information and internal control important to the government?

8.6 Financial information is a key part of the government's reporting and decision making and arises from its financial affairs and transactions. For example, as reported in the 2003–04 *Public Accounts of Canada*, the government raised almost $200 billion in revenue, incurred expenses of approximately $190 billion, had assets of almost $200 billion, and had liabilities of about $700 billion. Departments and agencies use this information when monitoring the delivery of programs and services, exercising stewardship over resources for which they are responsible, supporting decisions, managing risks within the organization, and reporting on the department and agency financial and operating results.

8.7 Under accrual accounting, these transactions and other economic events are recognized when they occur, rather than when cash or its equivalent is received or paid. Expenses are recorded in the period when the goods or services are consumed, revenues are recorded in the periods to which they pertain, and the multi-year economic benefits associated with capital assets are recognized in the period in which they are used.

8.8 Accrual financial information helps users appreciate the full financial scope of government—the resources, obligations, financing, costs, and impacts of its activities, including the costs of consuming assets over time. This more complete picture helps legislators hold the government more accountable for the stewardship of its assets, the full costs of its programs, and its ability to meet short-term and long-term financial obligations.

8.9 Internal controls refer to management's action to mitigate risks and achieve objectives. Controls contribute to this goal by

- safeguarding assets;
- reducing the risk that data may be incorrect or corrupt;
- ensuring proper authorization of transactions and compliance with policies, procedures, laws, and regulations; and
- ensuring the economical and efficient use of resources.

8.10 Complete financial information and strong internal controls are vital for achieving results for Canadians. Integrating financial and non-financial information into decision making, establishing effective financial information systems and controls throughout government, and establishing financial policies and procedures all lead to improving stewardship in government.

8.11 As managers become more aware of the complete picture of their financial performance (all costs, revenues, assets, and liabilities), they are more inclined to consider the complete cost while making various decisions, such as evaluating the cost-effectiveness of in-house delivery versus contracting for services, the appropriateness of cost recovery policies, and the amounts charged to other departments for services.

8.12 Finally, improved financial information and controls should enable departments and agencies to provide, on a more timely and regular basis, parliamentarians and central agencies with a variety of financial reports that compare actual information (both financial and non-financial) with budgeted or planned information in a manner that is consistent with the preparation of the summary financial statements of the Government of Canada.

What has happened since our last Report?

8.13 Before we published our March 2004 Report, Chapter 6, Managing Government: Using Financial Information, the government presented its 12 December 2003 reorganization plan. The plan aimed the Treasury Board of Canada Secretariat's focus toward comptrollership and financial management, including oversight of such matters in departments and agencies. Specifically, the Treasury Board Secretariat will ensure that departments and agencies meet all requirements for expenditure planning, control, and oversight. As well, the reinstatement of a distinct Office of the Comptroller General within the Secretariat enhanced financial accountability as did the announced positions of departmental comptroller. The 2004 Budget and associated press releases re-emphasized these commitments to strengthen financial management and control. Specifically, the government announced that, among other things, it would

- appoint professionally accredited departmental comptrollers to sign-off on all new spending initiatives in every government department;
- establish professional certification standards for departmental comptrollers by the end of the 2004 calendar year that must be met within three years;
- reorganize and bolster the internal audit function on a government-wide basis to ensure comprehensive audit programs that are based on sound risk analysis of all department activities and that have the authority to delve into every corner of every portfolio;
- provide appropriate tools for effective scrutiny and decision making and introduce modern, timely, and enterprise-wide financial and human resource information systems to track all spending; and
- arrange for the audit of the annual financial statements of all departments and agencies within five years.

8.14 The government also embarked on several additional reviews of its management practices to ensure that performance standards are raised ever higher and that significant savings are generated from operations within four years. The reviews included consideration of matters such as the *Financial Administration Act*, corporate and administrative services, government procurement, and capital asset management.

8.15 The comptroller general is to provide leadership in the renewed area of financial management and stronger financial controls within departments and agencies. Key duties to accomplish this objective include the following:

- approving the appointment of all departmental comptrollers and providing them with advice and guidance on sound financial management and administrative practices and procedures;
- overseeing all government spending, including the review and sign-off of new spending initiatives;
- modernizing the government's financial management suite of policies; and
- managing the professional development of the financial community, including establishing accreditation and certification standards and advising on financial management modules of the public service learning curriculum.

Focus of the follow-up

8.16 In this chapter, our objective was to determine whether the government is achieving two of its wider financial management and control initiatives:

- improving the quality of financial information produced by new financial information systems, and
- ensuring that such accrual information is used in decision making.

8.17 We also explored the government's progress in addressing accrual budgeting and appropriations at the department level and how selected departments and agencies addressed previously identified weaknesses in internal financial controls and accrual financial information.

8.18 Further details are included at the end of the chapter in **About the Follow-Up**.

Observations and Recommendations

Central and departmental leadership and capacity remain necessary to ensure success

8.19 Our previous chapters on financial management and control have highlighted the importance of leadership in improving the quality and use of the government's financial information. Further, they noted that achieving the necessary cultural change associated with the issues reported in this chapter will require more than providing extra guidance or sharing best practices among departments and agencies. Strong individual leadership from central agencies and senior departmental officials is necessary to reinforce that the government is committed to improving the use of financial information and financial information systems.

8.20 **Role of the Office of the Comptroller General.** In that respect, the recently announced re-instatement of a separate Office of the Comptroller General of Canada and the appointment of the Comptroller General presents an excellent opportunity for the Comptroller General to develop a strategy to handle his various responsibilities in a way that responds to our recommendations on

- overseeing and monitoring departments' and agencies' actions for improving their financial control systems,
- increasing departments and agencies' professional accounting capacity,
- aggressively advancing the use and timely preparation of accrual financial information in the decision making process, and
- resolving any outstanding issues pertaining to preparation of departmental financial statements.

8.21 In particular, we believe that the Comptroller General should explain fully the significance of the recent announcements regarding the role of departmental comptrollers, their accreditation, and the relationship, if any, with current senior financial officer positions. In that last regard, we understand that consultations with the senior financial community have already begun. However, several senior financial officials within departments and agencies told us that such a position already exists within their organization as do all the identified responsibilities and accountabilities announced to date within the position of the senior financial officer. They also indicated that, given the role already identified for senior financial officers and other relevant guidance, there should only be minor changes expected to that position in order to respond to the objectives announced for departmental comptrollers.

8.22 **Background and expertise of senior management team.** Deputy ministers and senior departmental financial officials also need to play a critical role in improving the use and timely preparation of financial information and the related financial internal control systems. The senior management team of a department or agency, in our opinion, needs to have the necessary backgrounds and/or professional training in all relevant disciplines, including accounting, in order to fulfil this role. This means a balance of expertise and perspectives within the senior management ranks—not just a cadre of professional financial managers.

8.23 A background and training in financial management, including accounting, helps the championing of financial management and control in departments. For that reason, and given the importance of financial capacity in departments and agencies, we updated our 2002 survey of professional accountants holding senior financial officer and senior full-time financial officer positions in 11 of the larger departments and agencies. We discovered that the percentage of incumbents that were professional accountants had increased from 33 percent to 55 percent. As a result, progress is being made but it still falls short of our 2002 comparison, where 80 percent of the senior financial officers in the 10 top revenue generating Canadian public companies were professional accountants.

8.24 The continued leadership and support of senior management, both centrally and within departments and agencies, is crucial to the government's objectives of improved financial information for decision making and improved financial information systems. Without it, these objectives risk losing momentum and becoming just another passing management fad. For that reason, we are supportive of the Comptroller General's efforts to support the professional development of the government's financial community, which include establishing accreditation and certification standards, advancing the role of internal audit, and understanding the profile and needs of financial officers within government.

8.25 **Recommendation.** The Comptroller General, in conjunction with senior financial officials in departments and agencies, should develop a vision, strategy, and implementation plan with key milestones for promoting financial management and control initiatives. The plan should also include milestones for improving the financial capacity in departments and agencies that are consistent with the government's announced support in this area.

Treasury Board Secretariat's response. Since accepting the position in June 2004, the Comptroller General has made significant progress in advancing the government's plan to strengthen comptrollership. During 2004–05, the Comptroller General will design the organization of the Office of the Comptroller General and begin staffing the new organization with high-calibre professionals so that the Office will be substantially completed by 31 March 2006 and fully completed by 31 March 2007.

At the same time, plans and activities will focus on capacity building and community development, strengthening financial accountability and financial systems across the public service, and creating capacity within the Office of the Comptroller General to conduct audits for small agencies and horizontal audits on behalf of the government.

On 18 November 2004, the President of the Treasury Board announced a multi-year initiative, being developed by the Comptroller General, to strengthen the internal audit function across the federal government. The multi-year initiative will enhance the internal audit capacity across the public sector and introduce standardized, proven audit processes.

In order to have the skilled, well-trained, and developed workforce necessary to strengthen public service management, the Treasury Board Secretariat, in partnership with the Canada School of Public Service, the Public Service Human Resources Management Agency of Canada, and functional communities, will develop a core learning framework to provide clear, consistent, and comprehensive programs to meet the common learning needs of public service managers. In 2004–05, the Secretariat began government-wide consultations on the development of professional certification standards. By the end of the year, the Secretariat plans to have defined and established the standard-setting process and developed certification standards for selected functional communities.

Specific to the financial management community, the Comptroller General has developed a draft vision and strategy for the departmental comptroller. Built around the model of a Chief Financial Officer (CFO), the position would be the single point of accountability for financial management in a department, reporting directly to the Deputy Head for overall performance and functionally to the Comptroller General for professional performance. The vision, which has been discussed with senior financial management in departments and agencies, includes the proposed roles and responsibilities of the position and its relationship with other key players in departments and the Secretariat. Experience and professional and personal attributes and competencies for the CFO position have been developed and key transition issues identified. The strategy also includes other human resource investment plans for recruiting and developing qualified financial officers to support the CFO.

Improvements in financial internal control systems are needed to support good-quality financial information

8.26 Strong financial internal controls help protect the integrity of the information used for decision making. They also contribute to the safeguarding of resources, accurate and timely reporting of results, and ensuring compliance with relevant authorities.

8.27 Since our Report in December 2002, Chapter 5, Financial Management and Control in the Government of Canada, we have continued to evaluate key financial controls governing selected computer information systems used for financial reporting of government expenses and revenues, assets and liabilities, as well as related management and monitoring controls (see Appendix A). We intend to continue these reviews over the next few years so that eventually all of the key financial systems and applications used for financial reporting in the largest departments and agencies are reviewed.

8.28 **Previously reported weaknesses remain.** In our March 2004 Report, Chapter 6, Managing Government: Using Financial Information, we prioritized those control weaknesses arising from our controls assessment work that we believed should receive particular attention (see Appendix B). While this is neither an all-inclusive list of control weaknesses nor an examination of all other operational system controls that may be present, departments and agencies need to address them, if they exist, within a reasonable period to avoid an impact on the quality and timeliness of information used for their decision making and financial reporting.

8.29 As a result, we expected that a subsequent assessment and review of the progress made by departments and agencies in addressing these control weaknesses would show significant improvements. We also expected that any additional control assessments undertaken by this Office would no longer identify the significant weaknesses previously reported. However, in our most recent reviews we continued to identify the same weaknesses that we reported in our two previous chapters.

8.30 To demonstrate the progress made by departments and agencies in addressing the financial control weaknesses we had previously reported, we reviewed the results of their actions taken in response to the previously identified weaknesses where we had performed the original financial control assessments in 2001 and 2002. The level of progress achieved in the departments and agencies reviewed varies (Exhibit 8.1). While some departments made significant progress in a timely manner, others made limited progress even though many departments and agencies had indicated that they had plans to address these issues.

Exhibit 8.1 Progress made by selected departments and agencies in addressing financial control weaknesses previously identified

These ratings reflect the progress made by a department or agency in addressing the weaknesses identified in our original control assessments that were completed in 2001 and 2002. They are not intended as a comparison of progress between entities, because of the differing quantity, nature and complexity of weaknesses. The ratings are not intended as an overall assessment as to effectiveness and efficiency of internal controls within a particular financial system of a department or agency, nor of the relative manner in which the various system implementations are designed. (See Appendix A for additional details.)

Financial systems for reporting expenses incurred

Departments and agencies	Financial systems	Controls			
		Electronic security	Monitoring	Manual processing	Control features optimization
Agriculture and Agri-Food Canada	SAP	●	●	●	●
Public Works and Government Services Canada	Regional Pay System	no weaknesses reported (NWR)			
	Common Departmental Financial System (CDFS)	●	●	NWR	N/A
Canadian Heritage	SAP	◓	◓	◓	◓
Veterans Affairs Canada	Free-Balance	●	●	NWR	NWR
	General IT Environment	◓	◓	◒	NWR
	Client Service Delivery Network (CSDN)	◒	●	◒	N/A
Canada Revenue Agency	SAP–Corporate Administrative System (CAS) expenditure system*	◒	◓	●	◓

*This financial system at Canada Revenue Agency is a larger installation of SAP that also integrates a human resource module.

Financial systems for reporting tax revenue

Agency	Financial systems (revenue reporting systems)	Controls			
		Electronic security	Monitoring	Manual processing	Control features optimization
Canada Revenue Agency	IT environment for the mainframe	◒	◒	◓	N/A
	SAP–revenue ledger (pre-implementation review)	◒	◓	●	◓
	T1 assessment/accounting	◒	◓	●	N/A

Other financial control processes identified in our financial audit of the Public Accounts

Departments	Controls			
	Monitoring	Manual processing	Payroll	Authorities
Agriculture and Agri-Food Canada	NWR	NWR	NWR	●
Canadian Heritage	NWR	NWR	●	◒
Public Works and Government Services Canada	◓	●	NWR	◒
Veterans Affairs Canada	●	◒	◓	◓

● **Significantly addressed.** Most of the original significant audit findings have been fully addressed.

◓ **Satisfactory progress.** Substantial progress has been made in addressing the original audit findings, but some additional action is still required.

◒ **Some progress.** Some progress has been made in addressing the original audit findings, but considerable additional action is still required to achieve the desired results.

○ **Unsatisfactory progress.** Progress has not been made in addressing the original audit findings, and action remains outstanding.

NWR: No weaknesses were reported for this category to the department or agency.

8.31 After first identifying the control weaknesses in 2001 and 2002, we expected departments and agencies would have significantly addressed these weaknesses. We are aware, in evaluating the extent of progress achieved, that the control weaknesses identified for each entity differ in terms of quantity, nature, and complexity. Also, the nature, size, and complexity of the systems influence the level of progress achieved. For example, addressing financial control weaknesses related to the financial reporting of tax revenues on an accrual basis at the Canada Revenue Agency can be a significant challenge because agency officials must also consider the impact on many tax assessing sub-systems and be responsible for the entire volume of tax revenue transactions within the government.

8.32 During our review of these control assessments, a senior financial official indicated that one of the key factors contributing to their financial control weaknesses was that the systems and the applications were introduced without a corresponding re-engineering of operating processes within their department. As departments and agencies proceed with the implementation of new systems or substantial upgrades to existing systems, this past experience and our identification of common control weaknesses should be considered.

8.33 We also found that certain departments and agencies that successfully addressed some of the identified weaknesses had done so by improving some of their quality assurance functions. These functions review selected transactions to ensure accuracy and their compliance with significant authorities. For example, Agriculture and Agri-Food Canada is using a process that systematically identifies higher-risk transactions for review prior to payment. As well, samples of lower-risk transactions are selected and reviewed to confirm the adequacy of control processes.

8.34 When we first identified these control weaknesses, we noted that, in our opinion, most of the weaknesses could be resolved in a reasonable period. Thus, we expected more progress to have been achieved. However, certain entities have failed to make addressing these weaknesses a priority, because these systems do not generate the management reports used as the basis for management decision making. Instead, the information is exported to other applications and tools to produce the necessary reports. However, the Canada Revenue Agency has shown significant advancement in this area; it has integrated various corporate administrative systems with its financial expenditure systems. This integrated capacity links finance, administration, and human resource information; provides for the single capture of most data; and produces almost all management financial reports.

8.35 The government's challenge is to ensure that all departments and agencies focus on the different types of control weaknesses and how to effectively implement the changes in their management processes so that their financial information is improved.

8.36 **Importance of internal audit.** As we stated in our November 2004 Report, Chapter 1, Internal Audit in Departments and Agencies, the internal audit function is an important element in enabling deputy heads to ensure that their departments have an effective internal control system. Internal auditors conduct risk-based audits and identify, where necessary, improvements in an organization's risk management strategy and practices, in its management control framework, and the integrity of the information systems it uses for decision making and reporting. As an example, in our controls assessment work with the Canada Revenue Agency, we conducted our review of key controls jointly with the Agency's internal audit function.

8.37 **Recommendation.** The Office of the Comptroller General, in co-operation with departmental and agency management, internal audit groups, and audit committees, should ensure that departments and agencies identify and address the internal control weaknesses in financial information systems within a reasonable period.

Treasury Board Secretariat's response. The Office of the Comptroller General is following up with those departments and agencies reporting significant weaknesses in the financial control assessments done by the Office of the Auditor General.

The Office of the Comptroller General will also communicate to all departments and agencies that have not yet been assessed, information on the weaknesses that have been found to be common to many of the assessed departments. The Office will strongly encourage departments and agencies to be proactive in addressing these weaknesses.

As an initial step, the Office of the Auditor General was invited to brief all senior full-time financial officers on the objectives and common findings of their control assessments at a recent conference.

Advancement of the accrual budgeting and appropriations issue is critical

8.38 Previous chapters on financial management and control have highlighted the lack of progress in addressing accrual-based budgeting and appropriations at the department and agency level. The Standing Committee on Public Accounts has continued to support our recommendations on accrual budgeting and appropriations (see Appendix C) and has repeatedly urged the Treasury Board Secretariat to act on this issue. After several years of studying this issue, we expected the Treasury Board Secretariat to have developed and begun implementing an appropriate action plan.

8.39 **Other jurisdictions have moved forward.** As outlined in this chapter, our interviews with senior financial officials confirm that the lack of accrual-based budgeting and appropriations creates a disincentive for departments to use accrual-based financial information as part of their regular decision-making processes. As a result, we examined the practices of other jurisdictions. We found that Australia, New Zealand, the United Kingdom, and several Canadian provinces and territories (namely British Columbia, Alberta, and the Northwest Territories) have studied the issue, developed a position, and implemented an accrual budgeting and appropriations process that was appropriate for their particular needs.

8.40 **The federal government continues to study implementation.** However, the federal government still has not yet concluded its study of accrual budgeting and appropriations even though it has advanced various elements of that study since our last Report. For example, it has consulted with departments and agencies to obtain their perspectives on possible implementation strategies and has explored the impact of implementing accrual budgeting and appropriations for capital assets and the annual reference level update exercise. Progress, however, has been very slow and few resources have been assigned to the task.

8.41 We recognize that there are challenges with accrual budgeting and appropriations and that a department's annual cash requirements will continue to be important information for Parliament, but we cannot understand why the government has not moved beyond the study of this issue. We also understand that there is no international consensus on this issue, but other jurisdictions seem able to conclude on this matter and, in our opinion, Parliament would be better served if it also received full program cost information based on accrual concepts as part of the estimates and appropriations process. This approach would ensure that Parliament received information comparable with the accrual-based information included in the *Public Accounts of Canada* and the government-wide budget. Furthermore, the information that managers and Parliament use in their decision making would be on the same basis as other external financial reporting of government operations.

8.42 As previously stated, we believe that until government-wide and departmental budgeting and financial reporting are put on a common accrual basis, the government will not achieve its objective of having improved accrual-based financial information used in its decision making.

8.43 **Recommendation.** The Treasury Board of Canada Secretariat should promptly complete its study of accrual-based budgeting and appropriations at the department level and implement an approach for a common accrual basis of planning, budgeting, and reporting.

Treasury Board Secretariat's response. Because the impacts of adopting accrual budgeting and appropriations are major and far-reaching, the Secretariat continues to believe that a prudent and thorough approach to introducing changes in budgeting or appropriations is the most appropriate approach. Although the rate of change is slower than the Office of the Auditor General would like, progress is being made in the area of accrual budgeting.

The Secretariat has recently completed, and will soon present to the Treasury Board, its study of capital asset management. A specific recommendation of this study is to introduce the application of accrual budgeting to capital planning and management. Contingent upon the quality of the long-term asset plan and departmental performance, selected pilot departments would be provided non-lapsing asset funding over a three- to five-year time frame. Eligible departments must have a long-term asset plan conforming to a new long-term asset management policy and display the resources on an accrual and a cash basis

The Treasury Board Secretariat is currently examining the feasibility of running next year's Annual Reference Level Update exercise on an accrual basis as well as the cash basis on which it is presently based. Achievement of this objective would represent the most significant step yet taken toward across-the-board implementation of accrual budgeting. A specific objective would be for the Treasury Board to approve reference levels for all departments and agencies on an accrual as well as a cash basis. This should represent substantial movement to address the Office of the Auditor General's specific concern that expenditure authorities provided solely on a cash basis are an impediment to departments' full incorporation of accrual information into their financial planning and management.

Accrual financial information must become more than a year-end exercise

8.44 The implementation of new financial information systems and improved financial information within departments and agencies was never intended solely for the purpose of preparing year-end financial results and the summary financial statements of the Government of Canada. Although such information has been incorporated in the preparation of the government-wide budget and periodic monitoring of government-wide results, we expected departments and agencies to have integrated such information into their normal decision-making processes and interim financial reporting activities. In other words, we expected that accrual financial information would be used by departments and agencies throughout the year.

8.45 The Treasury Board Secretariat's response to our March 2004 chapter supported that expectation. The Secretariat noted that Treasury Board submissions and memoranda to Cabinet required both cash-based and accrual information. The accrual information would, in the Secretariat's opinion, have to become part of the process of preparing these documents and, therefore, considered in decision making.

8.46 **Accrual information remains largely a year-end exercise.** As a result, we discussed the role of accrual financial information with senior financial officials in departments and agencies that we selected for examination (see **About the Follow-Up** at the end of the chapter). We reviewed a selection of internal interim financial reports prepared for those officials as well as a sample of Treasury Board submissions prepared by those departments and agencies. We concluded that those departments and agencies use accrual financial information mostly at year-end when preparing financial information for inclusion in the summary financial statements of the government.

8.47 Senior financial officials within those departments and agencies supported our conclusion and our similar concerns from previous chapters. Without a consistent use of accrual financial information throughout all aspects of government financial operations, they saw little need for that type of information other than as part of the year-end summary financial statement reporting process.

8.48 Other comments received from members of the senior financial community in departments and agencies that may explain the limited use of accrual financial information included the following:

- Accrual accounting was largely implemented as an accounting exercise and not a management exercise; therefore, accrual financial information was not a priority for anyone other than financial managers and then, only at year-end.
- There is a learning curve because many operational managers do not understand the benefits of accrual accounting. Although they may know many of the theoretical concepts, they need additional training and practice to apply the concepts within their department or agency.
- Other than year-end financial reporting for the summary financial statements, ongoing operations of departments and agencies are not managed on an accrual basis. Managers' concerns and, thus, their measure of success in most situations is ensuring that budget information is properly input into the expenditure management system of the government, that expenditures against that budget are properly authorized and recorded, and that regular reports demonstrate a department's or agency's total expenditures against its budget—information that is mostly cash-based and primarily adjusted to an accrual basis at year-end.
- Many departments and agencies are largely responsible for only employee salaries and a selection of grants and contributions programs. The impact of accrual accounting in such situations is minor and limited largely to which period to record year-end transactions. Accrual financial information in those cases is not particularly revolutionary.
- Accrual financial information is seen as most helpful to those departments and agencies with large numbers of capital assets—those in which it is frequently important, for example, to consider whether to purchase or build a particular asset.

8.49 Our review of certain interim financial reports prepared by the departments and agencies that we selected for examination confirmed many of our concerns about the limited use of accrual financial information. Most of the reports were largely comparing cash expenditures with cash budgets without any information that addressed expenses and accrual budgets.

8.50 Our review of Treasury Board submissions and related documents was somewhat more promising. However, we found that accrual financial information was only used in new proposals, as required by the Treasury Board Secretariat, if the accrual information was or would be different than cash-based information.

8.51 While our audit work identified limited use of accrual financial information within departments and agencies, we did discover some good examples of its use that we believe demonstrate how it can help improve information for decision making (see case study, How accrual financial information improves information for decision making).

How accrual financial information improves information for decision making

National Defence. National Defence manages a significant number of tangible capital assets including armoured vehicles, naval vessels, aircraft, and helicopters. All of these assets contribute to the defence of Canada and Canadian interests. The original cost of these assets is recorded in the Public Accounts of Canada at approximately $44 billion. After years of amortization, the net book value of the assets is approximately $26 billion.

Accrual accounting gave the Department, for the first time, complete financial information on the cost and estimated amortization of its tangible capital assets. Consequently, it allowed National Defence to analyze the effect of this information on its overall goals, objectives, and costs of service.

National Defence is now comparing its original investment and its annual amortization and related operating costs with

- those of defence organizations in other countries, and
- the cost of replacing related assets and the operating and amortization costs of the newer assets.

The Department has a better understanding of the cost of maintaining its assets and can decide whether it should repair and maintain assets, replace the assets, or take some out of service.

Veterans Affairs Canada. Veterans Affairs Canada provides veterans and their dependants with compensation for disabilities and lost economic opportunities, and with health and social programs that honour the sacrifices of veterans.

The introduction of accrual accounting required the Department to change the way benefits to veterans were recorded in order to be consistent with the accrual accounting approach for pensions and other employee future benefits. The full cost of veteran benefits is now recognized in the year in which the benefit is earned or changed and not when it is paid in cash.

Recently, the Department amended the benefits it provides to veterans' survivors. It analyzed the cost of these amendments by considering the impact on its future cash flows and by evaluating the impact of those future cash flows on an accrual basis of accounting (i.e. the discounted cash flow of all future benefits). Initial results indicated that the cost of amending the benefit would be a substantial expense for the year in which the change was made and not fully consistent with other government fiscal objectives.

To address this cost issue, Veterans Affairs, in conjunction with other stakeholders, examined other veterans' benefits that had been identified for revision and highlighted savings by amending or modifying admissibility requirements for those benefits. It examined the future savings and found that the savings were similar to the incremental costs of amending survivors' benefits. By making both changes, the net impact of the changes was limited to approximately $50 million, as outlined in Note 6 to the summary financial statements of the Government of Canada, and the amendments were undertaken for the benefit of veterans and their survivors.

The Department and government had a better understanding of the costs of these programs and the components of the related liability—the full cost was considered as opposed to just the annual cash flow impact.

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The Department and government had a better understanding of the costs of these programs and the components of the related liability—the full cost was considered as opposed to just the annual cash flow impact.

8.52 In addition, our audit of the government's summary financial statements further supported our observations that accrual financial information remains largely a year-end exercise. We identified several errors in the application of the government's accrual accounting policies. We also found instances of departments and agencies failing to consider aspects of accrual accounting concepts for their assets and liabilities that they didn't correct until quite late in their financial statement preparation processes: for example, expenses recorded in the wrong fiscal period and the impact of the removal of assets from service.

8.53 Although none of these latter matters was sufficient to affect our conclusion on the fair presentation of the summary financial statements, they illustrate that departments and agencies are not yet considering accrual financial information as part of their routine management information practices but rather as part of the year-end exercise of preparing financial submissions for the summary financial statements of the Government of Canada. More timely and thorough reviews of the financial information produced by the underlying systems within departments and agencies need to be carried out so that management can address these issues before the year-end and so that financial information available for decision making and external financial reporting to Parliament can be accelerated.

Specific challenges related to financial reporting of accrual financial information still need to be addressed

8.54 As part of our audit of the summary financial statements of the Government of Canada, we continue to report the need for improvements in the financial information and financial reporting at the Canada Revenue Agency and the Department of National Defence as it relates to their respective responsibilities for the financial reporting of tax revenues/receivables and inventories on an accrual basis of accounting (see Canada Revenue Agency needs to improve financial reporting practices for tax revenues and receivables and National Defence needs to improve inventory costing practices).

8.55 While the implementation of accrual accounting for tax revenues/receivables and inventory was a significant and challenging task for the government and still requires a significant effort by the respective agency and department, both situations continue to highlight the need for all departments and agencies to continue to improve the quality of their accrual financial information and to make the preparation of such information a part of their regular periodic financial reporting practice and not simply a year-end exercise.

Canada Revenue Agency needs to improve its accrual financial reporting practices for tax revenues and receivables

The Canada Revenue Agency manages $56 billion in federal receivables, $33 billion in payables, and an estimated allowance of $7 billion for receivables that will likely be uncollectible (doubtful accounts). With these figures, the Agency also manages the revenues that the Canada Border Services Agency receives from customs and border operations.

The Agency primarily determines the tax accrual figures based on tax assessment information derived from various tax program systems and then supplements that information with estimates of tax revenue earned in the period based on payments made by taxpayers. These taxation systems, however, were never designed as accounting systems for the accrual of tax revenues. Extensive data manipulation, manual processing, reconciliations of information from various sources, and analysis of tax collectability are needed to prepare the tax revenue information for inclusion in the summary financial statements. Properly reporting tax revenues and receivables and making an allowance for doubtful accounts each year is important for assessing the amount of federal revenues to be reported and the cost of managing all of the government's tax receivables.

During our audit of the government's 2002–03 summary financial statements, we first noted that for some types of tax revenue, there were significant differences between the amounts in the Agency's summary financial records and the totals of individual detailed records from underlying tax program systems constituting that balance. Following analysis of these differences, the Agency decided to make an adjustment to its summary financial records. Unexpected differences such as those, however, are usually an indication of a problem with financial reporting practices. As a result, although these adjustments were made, we remained concerned that significant differences could recur each year.

We also noted in that audit that the Agency was not consistent in the way it evaluated the allowance for doubtful accounts. At the time, the Agency re-evaluated the estimate of the allowance for doubtful accounts, and we were able to conclude that the allowance was fairly presented, in all material respects, in the summary financial statements.

Our recent audit of the government's summary financial statements noted that the Canada Revenue Agency had implemented several improvements. The Agency completed a detailed review of the underlying causes of the differences in tax revenue amounts that supported its preliminary conclusion from the prior year and developed a multi-year plan to introduce accounting sub-ledgers for each of its tax revenue streams. The Agency also increased the extent that it reviewed the estimates of the allowance for doubtful accounts, improved the communication and training used to evaluate the allowance for doubtful accounts, and improved the consistency with which it evaluated collectibility.

However, our current year's audit work continued to identify differences between the summary and detailed records of some types of tax revenue. Further reviews of these differences by the Agency indicated that they resulted from causes that had not previously been identified. The Agency made corrections for these errors during the current year and reduced the overall amount of the unexplained difference, which enabled us to conclude that the tax revenue figures were fairly presented in all material respects in the summary financial statements of the Government of Canada. Still, the adjustments were made as a part of the year-end exercise of finalizing the financial accounts of the government. The regular financial management practices of the Agency did not identify or rectify these problems.

Canada Revenue Agency needs to improve its accrual financial reporting practices for tax revenues and receivables

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National Defence needs to improve inventory costing practices

Inventories at National Defence account for the largest part of the government's $6.1 billion in inventories. They include such items as ammunition and consumable supplies like uniforms and machine tools. Historically, the Department's inventory systems were designed to maintain a record of quantities and not regularly determine the monetary value of the inventory. Inventory purchases were simply expensed when purchased.

During our audit of the 2002–03 summary financial statements, we found that National Defence's inventory systems and costing practices did not provide accurate cost information on its inventory items. As a result, the Department could not independently support the prices of its inventory.

In our audit of the summary financial statements and our observations in the 2003–04 Public Accounts of Canada, we noted that the Department had instituted the following improvements:

- reviews of some of its older costs for items such as munitions and the required corrections,
- improvement of the controls that detect errors when inventory is recorded,
- establishment of an interdepartmental committee to discuss ongoing challenges in improving inventory records, and
- improvement of the information system that monitors inventory inflows and outflows.

However, we continue to note errors in the way the inventory is valued; for example, some of the costs of the inventory were not properly supported and current year transactions (purchases, usage, and obsolescence) were not properly recorded. Most of these errors were corrected by National Defence, and we were able to conclude that the inventory figures were fairly presented, in all material respects, in the summary financial statements of the Government of Canada. However, these corrections were largely made as part of the Department's year-end effort to prepare its financial submissions and not as part of its regular financial management practices.

8.56 **Recommendation.** The Office of the Comptroller General, in conjunction with department and agency deputy ministers, should ensure that departments and agencies have strategies, where applicable, for improving the quality and use of accrual financial information that supports their regular financial reporting, analysis, and decision-making process.

Treasury Board Secretariat's response. Accrual financial information is being used throughout the year, from the preparation of the monthly Fiscal Monitor to the requirement, as noted in the chapter, for accrual information in memoranda to Cabinet and Treasury Board submissions for new funding. Departments and agencies are required to submit monthly financial information on an accrual basis in trial balances sent to the Receiver General. Senior financial management in departments and agencies must attest to the completeness and accuracy of the financial information in these monthly trial balances, and the Receiver General issues reports on the data quality.

The requirement for departments and agencies to provide accrual financial information is being expanded. The Treasury Board Secretariat is currently working with the Department of Finance and the Privy Council Office on the guidance needed for the inclusion of accrual financial information in all

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The requirement for departments and agencies to provide accrual financial information is being expanded. The Treasury Board Secretariat is currently working with the Department of Finance and the Privy Council Office on the guidance needed for the inclusion of accrual financial information in all memoranda to Cabinet and Treasury Board submissions, not just those for new funding. As well, the Treasury Board Secretariat is examining the feasibility of requiring departments to provide financial plans on both a cash and accrual basis for the 2006–07 Annual Reference Level Update exercise.

Accrual accounting, implemented as part of the Financial Information Strategy, was not promoted as a year-end exercise. Much effort was spent working with managers in departments and agencies promoting the use of accrual financial information in decision making. However, an understanding of the importance and benefits of accrual financial information in the departmental decision-making process is a significant cultural change.

Central agency requirements for accrual financial information create the need to develop the capacity in departments and agencies to provide that information and foster a greater understanding of the importance and benefits of the information in the decision-making process. As evidenced in the case study in the chapter, there are signs that departmental management is beginning to understand the importance of accrual information. Other indications are that some departments are introducing quarterly financial statements for internal management purposes.

Improved departmental financial statements can advance the use of improved financial information

8.57 Part of the Treasury Board Secretariat's accounting policy framework requires departments and agencies to prepare auditable annual financial statements. Such financial statements, if prepared on an accrual basis of accounting, support improved financial management because they fully and accurately report the financial affairs of departments and agencies. For several years, some departmental corporations and most separate agencies have had their financial statements prepared on an accrual basis of accounting and subsequently audited. However, a large number of departments have not, in our opinion, reached the point of having financial statements prepared on a basis that would withstand an independent audit.

8.58 Senior financial officials said that auditing departmental financial statements would confirm the accuracy and completeness of the accrual financial information that is provided to senior management and might advance the use of accrual financial information for decision making. Therefore, there is clear support within departments and agencies to advance this issue as quickly as possible.

8.59 **Audited financial statements for departments within five years.** Given the importance of departmental financial statements and because the government announced in March 2004 that within five years all departments will have their annual financial statements audited, we expected that the government would have accelerated its resolution of any related outstanding issues and developed an approach to implement this initiative. We reviewed a sample of the unaudited departmental financial statements to assess whether they contained the elements that we considered necessary for fair presentation. We also discussed the preparation of these financial statements with senior financial officials within selected departments. Finally, we met with the staff of the Office of the Comptroller General of Canada to assess their plans to enable all departments and agencies to have audited financial statements within five years.

8.60 Our audit work identified several improvements:

- the transfer of several balances to departments and agencies that were traditionally controlled by central agencies; for instance, allowances for certain loans, investments, and advances;
- updated guidance to departments and agencies on improving their financial statements; and
- the publication of financial statements in departmental performance reports where the department or agency had satisfied all elements necessary for fair presentation.

8.61 Despite these improvements, the unaudited financial statements still do not provide accurate and reliable information on program costs and overall financial position because certain significant items still remain under the control of central agencies, including provisions for severance liabilities, contingent liabilities, and environmental liabilities. As a result, users of these unaudited financial statements do not get a complete picture of the department's or agency's costs of activities, assets, and liabilities and are, therefore, making decisions without complete information.

8.62 The Office of the Comptroller General understands that despite the improvements achieved, additional information is required to ensure that these financial statements are complete.

8.63 **Recommendation.** The Office of the Comptroller General should promptly resolve any outstanding issues regarding departmental financial statements and develop a plan to achieve the commitment of having audited financial statements within five years.

Treasury Board Secretariat's response. As noted in the chapter, the financial statements of agents of Parliament and those of most departmental corporations are currently audited and published. As well, the remaining departments and agencies are preparing annual financial statements on an accrual basis.

Each year since the implementation of the Financial Information Strategy on 1 April 2001, the Treasury Board Secretariat has devolved certain centrally recorded items to departments and agencies for inclusion in their financial statements. For the 2004–05 fiscal year, the Treasury Board Secretariat is devolving the recording of the allowances on additional loans, investments, and advances, as well as the accounting for environmental liabilities, only recently required to be reported in the summary financial statements of the Government of Canada.

In each case, the Treasury Board Secretariat must co-ordinate with the Receiver General and the specific department or agency to ensure that the initial accounting to devolve the balance is done accurately, and that the department or agency has the processes and capacity in place to continue accounting for the item in a timely and accurate fashion.

Of the centrally recorded items not yet devolved, the Treasury Board Secretariat has identified those items for which devolution is appropriate. Over the next few months, the Treasury Board Secretariat will meet with the Office of the Auditor General to discuss its plans as well as the capacity of the Office of the Auditor General to audit the statements of all departments and agencies.

Conclusion

8.64 Although the government continued to make progress in advancing the use of improved financial information in departments and agencies and in improving the quality of the systems supporting that information, we are disappointed that more work is still needed to resolve several outstanding issues.

8.65 The Office of the Comptroller General needs to actively advance the use of accrual financial information and promote good financial internal controls within government by

- monitoring and influencing departmental use of accrual-based financial information,
- developing a strategy to increase the representation of professional accountants in the senior financial positions within departments and agencies, and
- developing a plan to resolve any outstanding issues regarding departmental financial statements so as to achieve the commitment of having audited financial statements within five years.

8.66 Departments and agencies must improve their use of accrual-based financial information so that it becomes more than a year-end exercise that they undertake to comply with directives for preparing the summary financial statements of the Government of Canada. Departments and agencies must also strengthen their financial internal control systems, paying particular attention to electronic security controls, monitoring practices, and the integration of manual and electronic processing controls.

8.67 Finally, it remains essential that the government resolve the issue of accrual budgeting and appropriations at the department level. Although this complex issue needs to be considered carefully, the government has been studying it for many years and has made little progress. In our view, until government-wide and departmental budgeting and financial reporting are put on a common basis, the government will not be able to make the most effective use of its financial information. Departments and agencies will continue to see their performance measured against a cash budget and a cash appropriation and, therefore, will have little motivation to fully utilize accrual financial information as part of their regular management decision-making and reporting processes.

About the Follow-Up

Objective

The objective of this follow-up was to determine whether the government has made progress in achieving two of its wider financial management and control initiatives: improved financial information used in decision making along with improved quality of that information through the introduction of new financial information systems.

Scope and approach

The scope of the follow-up includes the larger departments and agencies[1] for which we reviewed financial information systems as part of our financial audit of the summary financial statements of the Government of Canada and for which we had completed a follow-up of those reviews. These departments and agencies included the following:

- Canadian Heritage,
- Agriculture and Agri-Food Canada,
- Veterans Affairs Canada, and
- Public Works and Government Services Canada.

In addition, our audit scope included the Treasury Board Secretariat where considerable responsibility for government wide financial accounting, management, and control issues rests. The Canada Revenue Agency and National Defence were included in our audit scope but only to the extent of monitoring significant issues related to the implementation of accrual accounting that had previously been reported: for example, the accounting for tax revenues and consumable inventories respectively and the follow-up of any financial information systems reviews.

This chapter includes issues that arose during our audit of the summary financial statements of the Government of Canada. Consequently, our audit approach relied on the nature, scope, and extent of that audit work. The audit of the summary financial statements was conducted in accordance with Canadian generally accepted auditing standards. We assessed whether the summary financial statements were fairly presented in accordance with the government's stated accounting policies. The procedures we followed included testing of transactions and account balances, performing analyses, confirming year-end balances with third parties, reviewing significant internal controls as necessary, and discussing matters with government officials.

In addition to the audit work performed for the summary financial statement audit, we conducted interviews with senior officials regarding the use of accrual financial information, reviewed documents that contained financial information used to support financial decisions within government, and reviewed other audit work done by the Office of the Auditor General of Canada in the area of financial management and control in the government

Criteria

In respect of those departments and agencies selected for examination, we expected, where applicable, the following:

- Departments and agencies would have improved their internal financial control systems and addressed all significant weaknesses we identified in 2001 and 2002.
- Departments and agencies would have integrated accrual financial information into their regular decision making.
- Departments and agencies would have increased their professional accounting capacity, when appropriate, and developed appropriate plans to implement the new oversight responsibilities of the departmental comptroller.

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[1] Departments and agencies—Refers to only the specific department's or agency's operations as identified in the Government's Expenditure Plan and Main Estimates and not all of the other agencies or entities that may report to the selected department or agency through the government's reporting processes.

- The Treasury Board Secretariat would have developed a strategy to oversee and monitor actions within departments to improve financial control systems, professional accounting capacity, the use of accrual financial information, and the preparation of departmental financial statements.
- The Treasury Board Secretariat would have concluded its study of accrual-based budgeting and appropriations and developed an implementation plan.
- The Treasury Board Secretariat would have finished developing the approach to implement the remaining accrual accounting policies for departments and agencies and transferred the remainder of the central accounting processes that will allow for complete departmental financial statements.

Audit team

Assistant Auditor General: Doug Timmins
Principal: Clyde MacLellan
Director: Daniel Paquette

Sophie Boudreau

Appendix A Scope of controls assessment work

Since our December 2001 Report, Chapter 1, Financial Information Strategy: Infrastructure Readiness, we have continued to evaluate certain financial controls governing selected computer information systems, along with the related management and monitoring controls. Our objective was to determine the extent to which the selected financial internal controls of various departments and agencies were sufficient to contribute to the safeguarding of assets and the accuracy, completeness, and proper authorization of financial information related to our audit of the summary financial statements of the Government of Canada. However, the scope of our audit work was neither designed nor sufficient to express an opinion as to the effectiveness or efficiency of all internal controls within the selected departments and agencies nor to compare one entity's progress against another. The scope of our audit also may not identify all matters that might be of interest to management.

	Selected financial information (FIS) strategy system reviewed			Legacy systems[1] to be reviewed	
Entity	Year of initial assessment	Number of systems	Year of follow-up	Year of initial assessment	Number of systems
Agriculture and Agri-Food Canada	2001	1	2004	2004	2
				2005	1
Canada Revenue Agency	2001	2	2004	2003	2
	2002	2		2004	2
				2005	2
Canadian Heritage	2001	1	2004	2003	1
Public Works and Government Services Canada	2002	2	2004	2004	3
Veterans Affairs Canada	2002	2	2004	none	
Department of Foreign Affairs and International Trade	2002	1		2005	1
Indian and Northern Affairs Canada	2002	1		2002	2
Transport Canada	2003	1		2004	2
				2005	3
Citizenship and Immigration	2003	1		2005	2
Health Canada	2003	1		2005	2
Industry Canada	2003	1		2005	2
National Defence	2004	1		2004	3
				2005	6
Fisheries and Oceans Canada	2004	1		2005	6
Canadian International Development Agency	2004	1		none	
Royal Canadian Mounted Police	2004	1		2005	1
Correctional Services	2004	1		none	
Human Resources Development Canada[2]	2004	1		2004	2
				2005	2

[1] Legacy systems are existing systems made up of centralized processing systems. Usually, they are older mainframe and minicomputer information systems that have been running for many years.

[2] HRDC was divided into two entities, Social Development Canada and Human Resources and Skills Development Canada. Both still operate with the same systems and applications as before the reorganization but are now managed within Social Development Canada.

Appendix B Common weaknesses found in many internal financial control systems that need particular attention

Financial systems and processes	Weaknesses	Explanation and implications
Electronic security controls	• User access rights and privileges reflect incompatible duties. • Super user accounts are not sufficiently controlled. • Users have wider system access than required. • Generic user IDs are used, impairs accountability. • Best practices for key security parameters are not being enforced.	Electronic security controls are used to control user access rights and privileges within an electronic financial information system. Lapses in or inadequate electronic security controls could lead to unauthorized access, which can then allow for accidental or intentional corruption or loss of information. This can also result in the integrity of system tables and structures being compromised or in erroneous reports being produced by the systems.
Monitoring controls	• Security administration function does not follow best practices. • Reconciliation of accounts is not being done on a timely basis. • Review of clearing and suspense accounts is not timely. • Policies and procedures for monitoring accounts are not always in place—for example, review of unusual or high-risk transactions and review of key performance measures such as "receivables aging."	The security administration function is shared among many users and not controlled. There are no formal policies and best practices in place, leaving this position at risk. Monitoring controls engage senior management in analyzing the reasonableness of financial information. Differences identified or matters observed must not only be highlighted but investigated and analyzed with corrective action taken. A lack of monitoring controls allows errors to go unnoticed, thereby compromising data accuracy and validity as well as increasing the risk of loss and/or corruption of data.
Control features optimization	• Many controls features inherent in the new financial systems are not being used.	Not taking full advantage of these financial control features results in lost opportunity to increase efficiency and effectiveness of the operations. Options not optimized include functionalities to ensure each payment is matched to a requisition and evidence of receipt of goods/services and report generation. Not using built-in controls could reduce the consistency of the application of the controls. Also new financial systems are often used to simply compile results produced from existing systems. In some cases, two or more systems are operating where integration may be possible. This approach adds to the complexity and cost of maintaining financial information. There is also additional room for error if separate systems are maintained.
Manual processing controls	• Segregation of duties is inadequate. • Documentation on policies and procedures is not being prepared/reviewed. • Quality assurance of the account verification process is limited.	Modern control frameworks should allow for proper integration of manual processing controls within an electronic framework. Manual controls are less systematic and less comprehensive in their application than electronic controls. Bypassing the electronic framework increases the risk that data values will remain unchecked, be omitted, or result in duplicate information or other errors.

Financial systems and processes	Weaknesses	Explanation and implications
Selected authorities controls	Payments are being certified without • documentation of having received the goods, • proper delegation of signing authority, and • authorization.	Section 34 of the *Financial Administration Act* requires that proper authorization be obtained and that goods or services are received prior to any payment made. Section 33 of the Act requires that proper authorization be obtained prior to any requisition for a payment out of the Consolidated Revenue Fund and the subsequent charge against appropriations. Without proper controls, the government does not have assurance that payments are made only for goods or services that have been received.

Appendix C Standing Committee on Public Accounts: Recommendations on accrual appropriations/budgeting and the government's response

Report date	Recommendation	Government response
December 1998	The Treasury Board Secretariat should complete its consultations with its stakeholders as quickly as possible in order to determine the best possible options to move the appropriations (supply) process to full accrual basis.	Progress is slower than anticipated. Response to a consultation paper is expected by 10 March 2000, from which recommendations to the government will be made in the following two or three months.
March 2000	The Treasury Board Secretariat should complete its consultations with departments and agencies on moving to accrual appropriations. Once the consultations are completed, the Treasury Board Secretariat should inform Parliament and the Public Accounts Committee in writing of its final decision and recommendations to the government on moving to accrual appropriations.	Responses to the consultation paper have been received and are being compiled and analyzed. Completion of the analysis is expected by September 2000, although further review of accrual-based budgeting and its relationship with appropriations may be required.
March 2001	The Treasury Board Secretariat should complete its consultations with parliamentarians aimed at determining the best possible options to convert the appropriations (supply) process to a full accrual basis and report the results to the House of Commons by 31 March 2002; the Government of Canada should move to an accrual-based system of appropriations (supply) by 1 April 2003.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. Any decision made will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.
May 2001	The Treasury Board Secretariat should undertake and complete the required studies and consultations on full accrual-based appropriations, and it should prepare a set of proposals and alternatives to be presented to the House of Commons Standing Committee on Public Accounts, no later than 31 March 2002.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. The decisions made respecting any contemplated changes to our budgeting and appropriations practices will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.
December 2002	The government should adopt the integration of full accrual-based budgeting and appropriations into the Canadian Expenditure Management System and advise the Public Accounts Committee when the decision has been made. Once the decision is made to move toward full accrual-based budgeting and appropriations, the Treasury Board Secretariat should immediately prepare an action plan together with an implementation timeframe and table both these documents with the Public Accounts Committee.	Adopting the integration of full accrual-based budgeting and appropriations into the Expenditure Management System could have far reaching implications for government and for Parliament. Unlike accrual accounting, there is not international consensus on the adoption of accrual budgeting. Those countries that have implemented accrual budgeting have adopted specific accrual tools to suit their specific need and to help them implement much broader reforms. Moreover, some countries have indicated that their accrual budgeting frameworks are not yet proven and may be subject to change in the context of lessons learned. We intend to learn from their experience.

Source: Adapted from reports of the Standing Committee on Public Accounts

FEBRUARY 2005

A Message from the Auditor General of Canada

Chapter 1 Information Technology Security

Chapter 2 Transport Canada—Overseeing the National Airports System

Chapter 3 Modernization of Human Resources Management: Managing the Reforms

Chapter 4 Accountability of Foundations

Chapter 5 Canadian International Development Agency—Financial Compliance Audits and Managing Contracts and Contributions

Chapter 6 Canadian Nuclear Safety Commission—Power Reactor Regulation

Chapter 7 Governance of Crown Corporations

Chapter 8 Managing Government: Financial Information

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